www.pwc.com

What's Shaking in California?

August 7, 2014

pwc

pillsbury

Speakers

Chris Whitney
State and Local Tax Partner
PricewaterhouseCoopers LLP
601 S. Figueroa Street, Los Angeles, CA 90017
Office Phone: 213-356-6007
Email: chris.whitney@us.pwc.com

Kerne Matsubara, Partner
Pillsbury Winthrop Shaw Pittman LLP
4 Embarcadero Center, 22nd Floor
San Francisco, CA 94111-5998
Office Phone: 415-983-1233
Email: kerne.matsubara@pillsburylaw.com

Learning Outcomes

- Explore recent **legislative changes** in California, including the modifications to the current qualified small business stock statues, California's Economic Development Program, and proposed property tax provisions.
- Discuss **judicial updates** through recent California litigation.
- Understand **administrative developments** in California, including the application of the occasional sale rules in *Appeal of Emmis*, revisions to the intercompany transaction impacting Deferred Intercompany Stock Accounts, and various other California administrative developments.

pillsbury

California Legislative Update

pillsbury

Agenda: California Legislative Update

- California Credit Related Legislation
  - Enterprise Zone Tax Credit, California Competes Tax Credit, and the New Jobs Credit
- California Sales Tax Exemption for Manufacturers
- California Proposition 39
  - Single Sales Factor and Market-Based Sourcing
- Qualified Small Business Stock Gains
  - *Cutler vs. Franchise Tax Board* and A.B. 1412
- Proposed California Property Tax Legislation in A.B. 2372
- Corporation Tax Credits – Aerospace Industry

California Enterprise Zone Tax Credit

- A.B. 93 and S.B. 90 enacted on July 11, 2013 replaced California's Enterprise Zone ("EZ") program with a temporary Economic Development Program ("EDP").
    - Eliminates the current California EZ credit program after 2013.
- Qualified employees who are hired on or before December 31, 2013, continue to generate credit for the next four years.
    - Therefore, taxpayers can continue to calculate and claim hiring credits past 2013 for qualified employees hired before 2014.
- Applications for vouchering certificates are being accepted up to January 1, 2015.

California Enterprise Zone Tax Credit

- Carryovers of existing California EZ credits can be carried forward for ten tax years (as opposed to an indefinite carryover which historically existed under the EZ Program).
  - Ten tax-year carryover period begins with the first taxable year beginning after January 1, 2014.
    - Credits earned before 2014 would expire in 2024.
- Taxpayers should review the impact of the expiring EZ program.
  - Still have a limited time to take full advantage of existing rules.
    - Certain cities are discontinuing operations as enterprise zones, however, a third-party agent will be designated to voucher taxpayers in those zones.
  - Consider the impact of the new limitation on the carryforward period if you have significant credit carryforwards.

pillsbury

California Enterprise Zone Tax Credit

Example 1

The Greasy Spoon fast food restaurant chain has $20M EZ credit carryovers broken out as follows as of December 31, 2013:

Santa Ana	$10M	Los Angeles	$5M
Anaheim	$1M	San Diego	$4M

Since Greasy Spoon was projected to generate $1M of EZ credit annually and had capacity to utilize only $500K per year, Greasy Spoon had a full valuation allowance against its $20M of EZ credit carryovers for GAAP purposes.

With the passage of A.B. 93 and S.B. 90, Greasy Spoon is projected to be able to utilize $5M of its EZ credit carryovers from 2014 through 2024.

Issues

- Can Greasy Spoon reduce its valuation allowance by $5M?
- Is it legal for the state to reduce the value of credit carryovers which had an unlimited credit carryover period by retroactively instituting a ten year credit carryover period?

Exploring California's Economic Development Program

- Governor's Economic Development Initiative
  - California Competes Tax Credit: Started in March/April 2014; GO-Biz to administer.
  - Hiring Tax Credit: Started January 1, 2014; Franchise Tax Board to administer.
  - Sales Tax Exemption: Started July 1, 2014; Board of Equalization to administer.

GO-Biz: California Competes Tax Credit

- **What is the California Competes Tax Credit ("CCTC")?**
  - Contained in Revenue and Taxation Code sections 17059.2, 18410.2, and 23689, the CCTC is a negotiated tax credit between GO-Biz and: (1) businesses that want to relocate to California; and (2) businesses that want to stay and expand in California.
  - Written agreement must include:
    - Minimum employee compensation and retention period;
    - Credit distribution period; and
    - Recapture provisions if applicant fails to meet commitments.
  - Credit agreements must be approved by CCTC Committee (committee comprised of State Treasurer, Director of the Department of Finance, two legislative appointees, and Director of GO-Biz).

GO-Biz: California Competes Tax Credit

- **What factors will Go-Biz consider when awarding the credit as summarized on the Go-Biz website?**
  - Number of jobs created or retained
  - Compensation paid to employees
  - Amount of investment
  - Extent of unemployment or poverty in business area
  - Incentives available to the business in this state and in other states
  - Duration of the business' proposed project and the duration the business commits to remain in this state
  - Overall economic impact
  - Strategic importance of the business to the state, region, or locality
  - Opportunity for future growth and expansion in this state
  - Extent to which the anticipated benefit to the state exceeds the projected benefit to the business from the tax credit

GO-Biz: California Competes Tax Credit

- **Amount of credits available**
  - Tentative amount of credits available:
    - $30 million in fiscal year 2013/14
    - $150 million in fiscal year 2014/15
    - $200 million in each fiscal year 2015/16 – 2017/18
  - If GO-Biz does not award the full amount available in a given fiscal year, the difference is rolled forward to a subsequent year.
  - Any amounts recaptured from a taxpayer are added back into the amount available for disbursement.
- **Limits**
  - No more than 20% may go to any one applicant per fiscal year.
  - 25% of total amount each fiscal year reserved for small businesses.

GO-Biz: California Competes Tax Credit

- **Application Phase**
  - Each fiscal year Director will announce application period.
    - It is an online application submission and two-phase application evaluation process.
- **Negotiation and Award Phases**
  - GO-Biz and applicant negotiate terms of the contract.
  - GO-Biz will recommend fully executed contracts for Committee approval and make contracts public prior to Committee meeting.
  - Committee will either approve or reject terms of the contract.
  - Award information will be posted on GO-Biz website upon approval by the Committee.
    - Approximately $28.9 million approved tax credit agreements for fiscal year 2013/14 per GO-Biz website.

GO-Biz: California Competes Tax Credit

- **Schedule for Fiscal Year 2014/2015**
  - There will be three application periods:
    - To be determined (probably some time in September or October based on the announcement made at the previous committee hearing). This round will be for $45 million of the total available.
    - Beginning 1/5/2015 through 2/2/2015 for $75 million.
    - Beginning 3/9/2015 through 4/6/2015 for at least $30 million.
  - The committee hearings, which finalize the awards, will be held on:
    - January 15, 2015
    - April 16, 2015
    - June 18, 2015

GO-Biz: California Competes Tax Credit

- **California Competes Tax Credit Mechanics**
  - California Competes Tax Credit only applies as an offset against income/corporate franchise tax liability.
  - Credit is non-refundable, and if the credit allowed exceeds the tax, the excess credit may be carried over to reduce the tax in the following year, and in the succeeding five years, if necessary.
    - The statue does not address whether or not the credit can be used to reduce regular tax below the Tentative Minimum Tax ("TMT").
  - There is no minimum credit amount a business can request or be awarded.
  - Each negotiated and approved tax credit agreement will specify the terms of when the tax credit may be claimed.
  - Normal credit assignment rules under Revenue and Taxation Code § 23663 apply to the California Competes Credit.

GO-Biz: California Competes Tax Credit

Example 2

The Great Widget Company ("GWC") successfully applied for $6M of California Competes Tax Credits in April 2014.

For its 2014 tax year the following is projected:

Regular Tax Before Credits	$10M
Tentative Minimum Tax	$8M

Query

How much of the $6M of California Competes Tax Credits can GWC utilize in 2014?

A) The full $6M because regular tax is $10M?

B) Only $2M because the statue does not address whether the credit can reduce regular tax below TMT?

pillsbury

New Hiring Tax Credit

- Revenue and Taxation Code sections 17053.73 and 23626 provides the Hiring credit which is available to employers located in designated census tracts, former Enterprise Zones, and five Pilot Areas.
  - Up to five pilot areas may be designated for a period of four calendar years.
  - On April 24, 2014, GO-Biz designated three pilot areas: Fresno Pilot Area, Merced Pilot Area, and Riverside Pilot Area.
- Employers must:
  - Create a new net increase in jobs statewide.
  - Hire an employee who is:
    - Long-term unemployed, an unemployed veteran, ex-felon, a recipient of the Federal Earned Income Tax Credit, CalWORKS, or general assistance.
  - Provide a minimum of 35 hours per week on average.

New Hiring Tax Credit

- The credit is equal to 35% of qualified wages paid in the first five years.
  - Qualified wages are those in excess of 150% of California minimum wage (currently $12; or $10 per hour in pilot areas), and not greater than 350% of California minimum wage ($28).
  - Up to $56k per qualified employee ($63k in pilot areas).
- There are various timing requirements:
  - Tentative credit reservations
  - Annual certification
  - Credit can only be claimed on an originally filed tax return
- Available for hires on or after January 1, 2014 and before January 1, 2021.

New Hiring Tax Credit

- Hiring Credits not available for taxpayers in certain NAICS codes:
  - Employers that provide temporary help services, as described in NAICS code section 561320.
  - Employers that provide retail trade services, as described in NAICS code sections 44-45.
  - Employers primarily engaged in providing food services, as described in NAICS code sections 711110, 722511, and 722513 through 722515.
  - Employers primarily engaged in services described as casinos and bars as described in NAICS code sections 713210, 721120, or 722410.
- The term **"provide"** is not defined nor is the term **"primarily"** defined in the hiring credit section.
- Thus, it is possible that any employer "that provides" any retail trade or temporary help services would be barred from the new hiring credit, even if a preponderance of their business is not within the forbidden NAICS codes.

New Hiring Tax Credit

Example 3

Manufacturer's Unlimited is a company that manufactures a variety of products at its California facility. As an added benefit to its employees, the company has a cafeteria and gift shop at its facility. The company is looking to claim the New Hiring Tax credit, but is wondering whether or not it will qualify.

Query

Although the company provides very little food services or retail activities, could having a cafeteria and gift shop on its premises disqualify the corporation from claiming the New Hiring Tax Credit?

New Partial Sales/Use Tax Exemption

- California Sales and Use Tax Regulation section 1525.4 provides a new statewide sales/use tax exemption for a portion of the state sales and use tax on up to $200 million annually of certain manufacturing and research and development equipment.
  - Special-purpose buildings and foundations may also be exempt, including the tangible personal property used to construct them.
- Partial exemption rate is at 4.1875%, which is different from all other partial exemptions currently administered by the BOE. Most partial exemptions currently administered by the BOE are at 5.25 %.
- Applies to purchases made from July 1, 2014 through July 1, 2022.
- Businesses that are **primarily engaged** in manufacturing and/or R&D activities described in NAICS codes 3111 – 3399, 541711, and 541712 are eligible.

New Partial Sales/Use Tax Exemption

- **What is "primarily engaged"?**
  - "Primarily engaged" means 50% or more of gross revenues are derived from the manufacturing or R&D activities.
  - Depending on the organizational structure, an entity may qualify either in whole or for specific **"establishment"** within the legal entity.
    - An "establishment" includes multiple or single physical locations, (including any portion or portions thereof), and those locations or combinations of locations (including any portion or portions thereof) designated as a "cost center" or "economic unit" by the taxpayer, where a qualified activity is performed, and for which separate books and records are maintained.
    - If the legal entity derives more than 50% of its revenues or operating expenses from a qualified activity, it would qualify.
    - If the entity does not qualify as a whole, establishments within the entity may qualify if it meets the 50% revenue or expense criteria.

New Partial Sales/Use Tax Exemption

- **Exemption amount and procedure for obtaining the exemption:**
  - Qualified person will need to issue an exemption certificate to their suppliers when making a qualified purchase in order for the retailer to exempt a portion of the sales tax on the purchase of qualified assets.
  - Retailer will be required to keep a copy of the exemption certificate in its records.
  - Exemption is limited to $200 million in qualifying purchases each calendar year, by each qualified person or by all qualified persons required or authorized to be included in a combined report under the Corporation Tax Law.
  - Exemption began July 1, 2014 and is effective through June 30, 2022.

New Partial Sales/Use Tax Exemption

Example 4

Really Big Markets, Inc. "RBM" sells groceries, including tortillas in its grocery stores throughout California. RBM manufactures its own tortillas to maintain their superior quality. The Company would like to obtain the partial sales tax exemption on the new tortilla manufacturing equipment it purchased, but first must determine whether or not it would qualify for the exemption.

Query

Under which of the following scenarios would RBM qualify?

A) RBM purchased the qualified manufacturing equipment for use in its facility to manufacture the tortillas. The facility is around the corner from its grocery stores.

B) Tortilla, Inc. purchased qualified manufacturing equipment to manufacture tortillas in a small corner of its largest grocery store.

- What if different books and records were kept for the manufacturing and the retail activities?
- What if the manufacturing activities were performed in a separate legal entity?

California Proposition 39: Single sales factor and market-based sourcing

- On November 6, 2012, California voters passed Proposition 39, which requires most taxpayers to apportion their California income using a single sales factor.
  - Taxpayers are required to use a single sales factor to apportion income to California unless they derive more than 50% of their gross business receipts from conducting one or more "qualified business activity," including banking and financial activities.
- Effective January 1, 2013, Proposition 39 also requires all taxpayers to source their receipts from sales of other than tangible personal property using the market-based sourcing rules.
- Proposition 39 may significantly impact California taxpayers that are required to change from cost of performance to market-based sourcing for sales of other than tangible personal property.

Cutler v. Franchise Tax Board: Gain deferral limited to in-state businesses facially unconstitutional

- Similar to federal income tax provisions in I.R.C. section 1045 and I.R.C section 1202, California allows individual taxpayers a 50% *exclusion* and/or a *deferral* on gains relating to the purchase and sale of qualified small business stock ("QSBS") under Revenue and Taxation sections 18038.5 and 18152.5.
  - Unlike federal provisions, California statutes limited this exclusion/deferral to investments in small businesses predominately based in California.
- On August 28, 2012, a California Court of Appeals ruled in *Cutler v. Franchise Tax Board* that the state's limitation of QSBS gain deferral to **in-state businesses** was unconstitutional.

pillsbury

Cutler v. Franchise Tax Board: FTB Response

- The FTB responded to the *Cutler* decision by announcing, in Notice 2012-03, that it would deny taxpayers the QSBS exclusion/deferral for 2008 and later years because the exclusion/deferral was "unconstitutional, invalid, and unenforceable."
  - Under the Notice, the FTB stated that it could not deny the exclusion/deferral to taxpayers in otherwise closed tax years because it must treat similarly situated taxpayers the same.
  - Since tax years prior to 2008 were beyond the statue of limitations, the FTB allowed the deduction to taxpayers that met all QSBS qualifications other than the unconstitutional in-state requirements.
- On February 28, 2013, the FTB provided on an FAQ web page that it was going to send Notices of Proposed Assessments to taxpayers in early April 2013 to ensure collection of denied QSBS exclusions and deferrals.
- The FTB also instructed taxpayers who claimed the QSBS deferral or exclusion to file amended returns back to 2008 and pay any tax as a result.

Cutler v. Franchise Tax Board: A.B. 1412 Signed by Governor Brown

- Governor Jerry Brown signed A.B. 1412 on October 4, 2013 which removes the unconstitutional defect limiting QSBS gain exclusion/deferral to only predominately in-state businesses.
  - A.B. 1412 modifies the current QSBS statutes (Revenue and Taxation Code Section 18038.5, 18152.5) and eliminates the previous requirement that 80 percent of business activity occur in California during the holding period.
  - Retroactively allows the QSBS gain exclusion/deferral for tax years 2008 – 2012, but FTB Notice 2012-3's guidelines still apply to tax years 2007 and prior, with an open statue.
- California taxpayers should consider filing refund claims for gains realized from prior years that may have otherwise qualified for gain exclusion/deferral but for any in-state business requirement.
- Taxpayers had until June 30, 2014, to file refund claims for the 2008 tax year.

Cutler v. Franchise Tax Board: Broader Implications?

- Contrast Cutler result with the Oklahoma's Supreme Court's recent decision that the state's capital gains deduction was a permissible tax incentive to promote Oklahoma businesses, and hence, the Commerce Clause was not implicated because the deduction did not target a specific common market or industry. (*CDR Systems Corp. v. Oklahoma Tax Commission*, Okla. Sup. Ct., No. 109,886 (4/22/14)].
  - The Oklahoma statue imposes a shorter holding requirement to receive the capital gains deduction for companies with their primary headquarters in Oklahoma.
- On May 12, 2014 CDR filed a motion for rehearing before the Oklahoma Supreme Court.
- If unsuccessful, and CDR requests, and is ultimately granted U.S. Supreme Court certiorari, could the U.S. Supreme Court's decision in this area have implications for other forms of state incentives (e.g., credits.)?

Property Taxation: Review of California Provisions

- Proposed legislation, A.B. 2372, would make changes to California's Proposition 13 in terms of when a change of ownership would be deemed to have occurred.
- Currently, Proposition 13 limits increases to assessed values on any given property to no more than 2% per year unless there is a change in ownership.
  - An exception is made in Cal. Const. Art. 13a Sec. 2(a) where real property, including legal entities owning real property, undergo a change of ownership.
  - Complications have arisen where interests in a legal entity are transferred in a series of transactions and/or to multiple transferees or buyers.

Property Taxation: Review of California Provisions

- For example, in *Shuwa Investments Corp. v. County of Los Angeles*, the California Court of Appeal held that Shuwa gained control of the ARCO Plaza complex in a three-step transaction and triggered a full change of ownership.
- In contrast, in *Ocean Avenue LLC v. County of Los Angeles*, the California Court of Appeal for the Second Appellate District held that sales of interests in the Fairmont Hotel in Santa Monica to multiple, albeit related, buyers did not constitute a change of ownership, because no single person acquired 50% ownership even though 100% of the property changed hands.

Property Taxation: Current California Legislation

- **A.B. 2372 Broadens "Change in Ownership"**
  - This bill would specify that if 90% or more of the direct or indirect ownership interests in a legal entity are cumulatively transferred in, one or more transactions, the transfer of the ownership interest is a change in ownership of the real property owned by the legal entity.
    - **"Transferred"** defined to exclude transfers of interests in publicly traded entities in the regular course of trading on an established securities market. It includes shares or interests acquired as part of a merger, acquisition, private equity buyout, transfer of partnership shares or "any other means" by which a change in ownership otherwise would occur.

Property Taxation: Current California Legislation

- **A.B. 2372 (continued)**
  - It affects transfers on or after January 1, 2015.
  - Increases reporting requirements and penalties.
    - The bill would increase penalties from 10% to 15% for failure to file Form BOE-100-B, *Statement of Change in Control and Ownership of Legal Entities*.
  - Once an interest has been counted for purposes of change in ownership, the interest will not be counted again.
  - The bill has passed the full Assembly and the Senate Governance and Finance Committee, and is scheduled to be heard in the Senate Appropriations Committee on August 4, 2014.

Property Taxation: Current California Legislation

- **Potential Impact**
  - Do you have proper Proposition 13 protection in your leases to protect from unintended reassessment?
    - Lessees under triple net leases may, if this legislation passes, be subject to substantial increases in their payments due to a wider range of lessor transactions which may result in a change of ownership.
    - Lessees should consider negotiating contractual terms to protect themselves from an unanticipated reassessment.

pillsbury

Property Taxation: Current California Legislation

Example 5:

ABC, Inc. has a triple net lease with REIT, LLC and is responsible for paying the property taxes, among other expenses.

MegaREIT, LLC buys REIT, LLC and triggers a change in ownership, which causes the property to be reassessed and increases the property tax.

If ABC, Inc. did not negotiate proper Proposition 13 protection into its lease then they will likely be responsible for the additional property tax due.

Corporation Tax Credits: Aerospace Incentives

- Governor Brown signed legislation, A.B. 2389, creating a $420 million tax break intended to benefit Boeing and Lockheed-Martin in a federal contract bid.
- The bill has two tax relief provisions:
  - **Local tax relief**: It expands the amount of property tax relief a local government can provide under the Capital Investment Incentive Program.
    - Currently, the law allows a rebate for property tax on the facility's assessed value in excess of $150M in value, but the bill lowers that threshold to $25M.
    - For example, a business pays property taxes on the first $25M of the facility's assessed value, then may receive a property tax rebate for the taxes paid on the facility's value above that amount.
    - The new $25M threshold only applies to businesses described in NAICS Code 3364 (Aerospace Product and Parts Manufacturing) and NAICS Code 3359 (Other Electrical Equipment and Component Manufacturing).

Corporation Tax Credits: Aerospace Industry

- **State tax relief:** Qualified taxpayers are eligible for a tax credit equal to 17.5% of wages paid to qualified employees.
  - "Qualified taxpayers" must be a "major first-tier subcontractor".
  - "Major first-tier subcontractor" means a subcontractor that was awarded a subcontract of at least 35% of the amount of the initial prime contract awarded for the manufacturing of a new advanced strategic aircraft for the U.S. Air Force.
  - Credit is available for full-time employees who spend at least 80% of their time directly related to the taxpayer's subcontract "to design, test, manufacture, or otherwise support production of property" for use in or as a component of a new advanced strategic aircraft for the U.S. Air Force.
  - The annual amount of the credit is limited to $25 million for the first five years, $28 million during the next five years and $31 million for the remaining five years.

California Judicial Update

California Litigation

Comcon Production Services I, Inc. v. FTB, LA Super. Ct. No. BC489779 (Mar. 6, 2014)

- Superior court held that Comcast was not unitary with QVC, a television channel in which Comcast had a 57% ownership interest
- No centralization of management, functional integration, or economies of scale between the two entities
- Court rejected FTB's arguments that because Comcast carried QVC and entered into certain joint ventures with QVC, there was a flow of value amongst the two companies
- Termination fee was business income

California Litigation

Gillette Co. v. FTB, Cal. Ct. App. (Oct. 2, 2012), petition for review granted Jan. 16, 2013

- Court of Appeal held that taxpayers could elect to use Compact's evenly-weighted 3-factor formula, rather than the double-weighted sales factor formula mandated under Cal. Rev. & Tax. Code § 25128
  - Compact as a binding agreement
  - Absent repeal, Compact's allocation and apportionment provisions available
  - California Legislature could not unilaterally modify the Compact's terms
- *Gillette* is fully briefed and pending oral arguments before the California Supreme Court

California Litigation

Harley-Davidson, Inc. v. FTB, San Diego Super. Ct. No. 37-2011-00100846 (May 1, 2013)

- Superior court held that two bankruptcy remote special purpose entities (SPEs) created for the purpose of bundling and selling securitized loans had substantial nexus with California
  - SPEs had no physical presence in California
  - Court focused on integrated relationship between the SPEs, Harley-Davidson financing subsidiaries and third-party Harley-Davidson dealers
- SPEs were financial organizations as they were in competition with national banks

California Litigation

Daniel V, Inc. v. FTB, LA Super. Ct. No. BC457301 (Mar. 13, 2013)

- Superior court held that taxpayer, a Nevada corporation, established that it was commercially domiciled in Nevada, so the income at issue was not taxable in California
- Court awarded attorneys' fees to taxpayer
- FTB filed a notice of appeal, but case was dismissed upon FTB request

pillsbury

California Litigation

Swart Enterprises v. FTB, Fresno Super. Ct. No. 13CECG02171

- Pending case involving issue whether a corporate taxpayer is doing business in California and subject to minimum tax solely through its ownership interest in a California LLC

California Litigation

Bunzl Distribution v. FTB, SF Super. Ct. No. CGC10506344

- Whether a nonresident corporate member of a “disregarded” single-member LLC that conducts business in California is a California taxpayer solely due to its LLC interest
- Suit also alleges that FTB Settlement Bureau policies and procedures violate the statutory settlement rules and constitute improper underground regulations
- Case pending on appeal
- Court of Appeal asked taxpayer to address whether a final judgment from which taxpayer could appeal exists in this case

California Litigation

FTB Legal Ruling 2014-01 (July 22, 2014)

- Business entity considered to be “doing business” in California merely by holding a membership interest in an LLC (taxed as a partnership) that is doing business in California
- Does not matter if LLC is member-managed or manager-managed
- Limits *Amman & Schmid* strictly to limited partners in a limited partnership
- LR 2014-01 issued during pending *Bunzl* and *Swart* cases

California Litigation

***Fidelity National Information Services Inc. v. FTB* (Sacramento Super. Ct.)**

- Whether gain from sale of minority stock interest is business income
- Constitutionality of LCUP also being challenged

***C.V. Starr & Affiliates v. FTB* (SF Super. Ct.)**

- Whether dividend and capital gain resulting from acquisition and subsequent sale of AIG common stock is business or nonbusiness income. Case settled.

***Mercedes-Benz USA Inc. v. FTB* (Sacramento Super. Ct.)**

- Whether income generated by pension assets is business income. Case settled.

California Litigation

Lucent Technologies, Inc. v. SBE, LA Super. Ct. No. BC402036 (Sept. 27, 2013)

- Licensing fees to operate switching equipment were exempt from sales tax under California's statutes regarding technology transfer agreements
- Follows *Nortel Networks v. SBE* (Cal. Ct. App. 2013) under nearly identical facts
- On April 18, 2014, court awarded $2.6M in attorneys' fees
- "In situations where there is clear binding precedent, it would be poor public policy to cause the taxpayer to pay these taxes on the basis that the BOE wants to further 'test the waters.'"

California Administrative Update

pillsbury

Agenda: California Administrative Update

- Application of California's Occasional Sale Rules in the *Appeal of Emmis*
- Deferred Intercompany Stock Accounts Amended Regulations
- Explore Other Recently Proposed and Promulgated Regulation Changes and Other Administrative Developments

Appeal of Emmis: Summary

- Under California Code of Regulations (CCR) section 25137(c)(1)(A), the occasional sale of a fixed asset or other property held or used in a taxpayer's trade or business is excluded from the sales factor.
  - For purposes of this rule, a sale is substantial if its exclusion results in a 5% or greater decrease in the sales factor denominator.
  - Also, for purposes of this rule, a sale is occasional if the transaction is outside of the taxpayer's normal course of business and occurs infrequently.
- Emmis Communications Corporation (Emmis) is a diversified media company that focuses principally on radio broadcasting, but also participates in magazines, television, and other activities.
  - During its 2006 tax year, Emmis sold 13 of its 16 television stations, all of which were located outside of California.
  - The sale resulted in gross proceeds of $931 million, which Emmis included in the denominator of its sales factor.

Appeal of Emmis: FTB's Position

- The California Franchise Tax Board (FTB) attempted to exclude the gross receipts from the sale of the television stations from the sales factor arguing the occasional sale rule applied.
  - The FTB argued that sale of the stations was an occasional sale because Emmis primarily generated revenue from selling advertising and was not in the business of divesting whole segments of its operations.
  - FTB characterized the series of transactions as one sale, that of the exit from the television broadcasting business.

pillsbury

Appeal of Emmis: Taxpayer's Position

- Emmis argued that:
  - (1) the acquisition and disposition of media properties were part of its operations and thus the television station sales were not occasional because the sales were an integral and ordinary part of its business, and
  - (2) that if the sales were deemed to be occasional sales and removed from the factor, including the gain from the sale in its income base (representing 100% of its unitary income) would be distortive without the corresponding receipts in the apportionment factor.

Appeal of Emmis: Board's Decision

- The Board decided in favor of Emmis, finding that the occasional sale rule did not apply to the television station sales.
  - As a result, gross receipts from the television station sales were included in Emmis' sales factor.
- There were two questions at issue: (1) whether the occasional sale rule applied to Emmis' television station sales and (2) whether excluding television station sales gross receipts from the apportionment factor was distortive.
- The SBE members' questions and discussion centered on the application of the occasional sale rule without reaching a discussion on the distortion question.
- Furthermore, the SBE did not offer any explanation as to the specific points that led to its determination. This means that taxpayers will receive little guidance from this case as to the SBE's view of the specific arguments.

Amended California Code of Regulations: Deferred Intercompany Stock Accounts

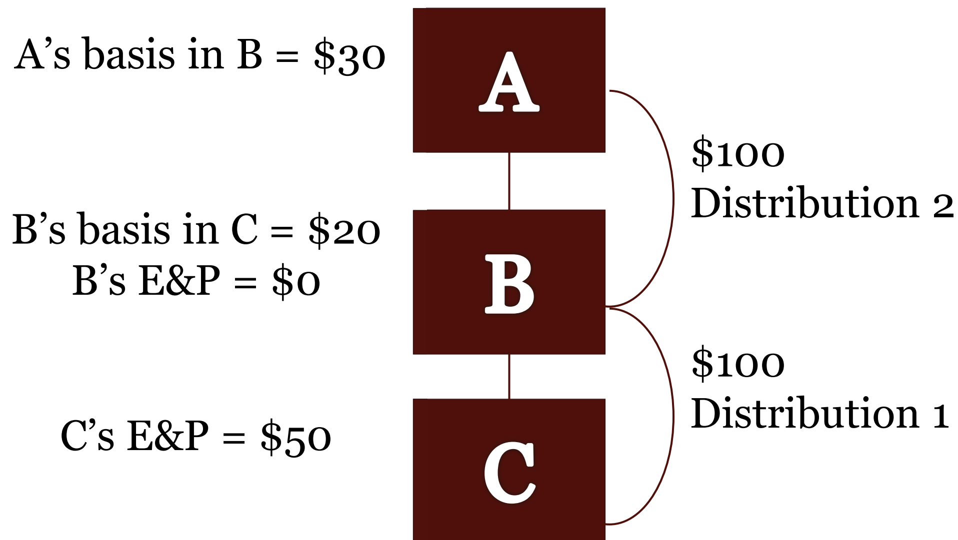
- Amended California Code of Regulations (Reg.) section 25106.5-1, regarding the treatment of Deferred Intercompany Stock Accounts ("DISA"), was approved by the Office of Administrative Law on January 8, 2014, and became effective April 1, 2014.
- The amended regulation addresses the following issues:
  - Merger with a brother/sister corporation will not trigger a DISA; instead, the deferred amount will be spread proportionally to the stock in the surviving entity.
  - Taxpayers can reduce DISAs by making subsequent capital contributions.
  - Distributions through various tiers of stock ownership will no longer create multiple, separate DISAs because any DISA arising from the initial distribution is included in current year E&P when determining the DISA arising from a second distribution.
- Changes may be applied prospectively or retroactively.

Amended California Code of Regulations: Deferred Intercompany Stock Accounts

Example 6: Distributions through a tiered subsidiary structure will no longer create multiple, separate DISAs.

- A owns stock in B with a basis of $30 and B owns stock in C with a basis of $20. In Year 1, C has accumulated and current E&P of $50. In Year 1, C distributes $100 to B, which in turns distributes $100 to A. B is a mid tier holding company with no E&P prior to the distribution from C .
- B has $50 of dividend income and E&P as a result of the distribution as well as a $30 DISA in the stock of C. Under the previous regulations, B's DISA in its C stock would not be included in B's E&P. As a result, A would have a $20 DISA in the stock of B.
- Under the amended regulations, B would have a $30 DISA in the stock of C, but A would have an $80 dividend and a $10 remaining basis in its B stock ($100 - $80 = $20 return of capital).

Amended California Code of Regulations: Deferred Intercompany Stock Accounts



Scenario #1 : Previous Regulations

After **Distribution 1, B** has the following:

$50 Dividend
$20 Return of Capital
$30 DISA

After **Distribution 2, A** has the following:

$50 Dividend
$30 Return of Capital
$20 DISA

Scenario #2: Amended Regulations

Distribution 1: Same results as above.

After **Distribution 2, A** has the following:

$80 Dividend (B's $30 DISA + $50 E&P)
$20 Return of Capital
$0 NO DISA

pillsbury

Amended California Code of Regulations: Deferred Intercompany Stock Accounts

Example 7

P has a manufacturing subsidiary, S, that performs R&D activity. S has intellectual property with a fair market value (FMV) of $100M with a basis of $0 since the intellectual property was self-developed. In Year 1, S distributes the intellectual property to P. P's basis in S is $20M.

The distribution triggers a $100M gain under IRC Section 311(b) in S which is deferred under the combined / consolidated return regs for Federal and CA for both the tax base and for E&P.

Assuming S has no other E&P, the above distribution would produce an $80M DISA in the stock of S.

Amended California Code of Regulations: Deferred Intercompany Stock Accounts

- These regulatory changes can be beneficial as they provide a way to eliminate or reduce a DISA through capital contributions, and to prevent DISAs from being inadvertently triggered if a taxpayer merges with a brother/sister corporation.
  - In addition, distributions moving through various tiers of stock ownership will not create multiple DISAs.
- Taxpayers tracking and reporting DISAs should consider reviewing previously reported DISAs to reflect any changes caused by these revisions, such as a DISA reduction or elimination caused by subsequent capital contributions.
  - Regardless of these changes, taxpayers will need to continue to track and report DISAs for California purposes.

pillsbury

California Regulations

Regulation 25136-2 -- Sourcing of sales from intangibles/services

- Third Interested Parties Meeting held on July 8, 2014
- Definition and rules for marketable securities
- Asset management fees not assignable under Reg. 25137-14
- Interest
- Dividends
- Goodwill

California Regulations

Regulation 25137-1 -- Apportionment of partnership income

- Third Interested Parties Meeting held on July 8, 2014
- Business v. nonbusiness determination made at the partnership level
- Intercompany sales within a unitary business eliminated from sales factor
- Principles extend to lower-tier partnerships held by taxpayer corporation
- Definition of “partnership interest”
- Corresponding changes to Regulation 17951-4 regarding partners who are nonresident individuals

California Regulations

Draft Regulation 23663 -- Credit assignment to combined group members

- Third Interested Parties Meeting held on June 12, 2014
- Treatment of defective assignments
- More favorable outcome the earlier a taxpayer requests to correct defective assignments

California Regulations

Proposed Regulation 24465-3 -- Transfer of appreciated property to insurer

- RTC Section 24465 allows for deferral of gain recognition if transferred asset is used in the active conduct of the insurer's trade or business
- Until the asset is subsequently disposed of and gain is recognized, an annual statement must be filed with FTB
- Proposed Regulation sets forth the contents of the annual statement and filing procedures
- No public hearing scheduled unless requested 15 days prior to close of the comment period on September 11, 2014

Thank you

This document is for general information purposes only, and should not be used as a substitute for consultation with professional advisors.

This document was not intended or written to be used, and it cannot be used, for the purpose of avoiding U.S. federal, state or local tax penalties.

© 2014 PricewaterhouseCoopers LLP. All rights reserved. PwC refers to the United States member firm, and may sometimes refer to the PwC network. Each member firm is a separate legal entity. Please see www.pwc.com/structure for further details.