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CALIFORNIA

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CALIFORNIA

Franchise and Income Tax

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.D.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. *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 taxpayer's hedging transactions were integral to its core business and held that such transactions generated gross receipts for sales factor purposes. However, since the trial court did not reach the RTC § 25137 distortion 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. Notwithstanding its decision in *General Mills I*, 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*, 208 Cal. App. 4th 1290 (2012) (*General Mills II*).

(7) The taxpayer did not seek review of the Court of Appeal's decision in *General Mills II*.

d. *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.

e. *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.

(b) Treasury function does not include trading activities of a registered broker-dealer.

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

4. Mandatory single-sales factor

a. For taxable years beginning on or after January 1, 2011, and before January 1, 2013, multistate taxpayers were permitted to make an irrevocable annual election on an original timely filed return to apportion its income using a single-sales factor. The election was not available to taxpayers listed in RTC § 25128(b), which derived more than 50 percent of their gross receipts from agricultural, extractive, savings and loan, or banking or financial activities. RTC § 25128.5.

b. Taxpayers that made the single-sales factor election were required to use market-based sourcing for the assignment of sales of intangibles and services. Former RTC § 25136(b). Taxpayers that did not make such election sourced such sales to the state where the greater proportion of income producing activity was performed, based on the costs of performance. Former RTC § 25136(a).

c. In November 2012, voters approved Proposition 39, which eliminated the single-sales factor election and requires most businesses to use a single-sales factor method of apportionment for taxable years beginning on or after January 1, 2013. Agricultural, extractive, savings and loan, and banking and financial businesses must continue to use an equally weighted three-factor apportionment formula. RTC § 25128.7.

d. For taxable years beginning on or after January 1, 2013, Proposition 39 requires the use of the market-based sourcing rules for sales of intangibles and services for all taxpayers, including agricultural, extractive and financial businesses. RTC § 25136(a).

e. The special sourcing rules for certain industries and transactions that are set forth in the FTB Regulations under Section 25137 (e.g.,

Regulation 25137-4.2 regarding banks and financial corporations) generally should continue to apply, subject to certain modifications.

f. Note: The FTB announced that mandatory single-sales factor apportionment applies not only to corporate taxpayers but to any "apportioning trade or business," including sole proprietorships, partnerships, limited liability companies and corporations. See FTB Tax News, April 2013.

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

a. FTB adopted Regulation 25136-2 to provide guidance on assigning sales of intangibles and services when market-based sourcing is required (i.e., for taxpayers that made a single-sales factor election, and, beginning in 2013, all taxpayers generally).

b. Under market-based sourcing, sales of intangibles and services 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 sales factor sourcing for sales of minority interests in business entities, asset management fees and dividends.

d. Second and third interested parties meetings were held on October 18, 2013 and July 8, 2014 to address additional issues,

including the sourcing of sales of marketable securities, interest, dividends, goodwill and sales of interests in start-up entities.

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. The return to *Finnigan* is limited to sales of tangible personal property and does not apply to sales of other than tangible personal property.

   c. On May 26, 2011 and October 4, 2011, the FTB held interested parties meetings to discuss proposed amendments to Regulation 25106.5 (sales factor; sales of tangible personal property; throwback sales), to implement the return of *Finnigan*.

   d. On February 6, 2013, the FTB held a public hearing on the proposed amendments to Regulation 25106.5. The proposed amendments were approved and became effective on January 1, 2014.

7. FTB Chief Counsel Ruling 2011-01

   a. FTB 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. 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 IX.A.1 below.

e. On October 2, 2012, the Court of Appeal issued its opinion in *Gillette* 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.

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.

g. On January 16, 2013, the California Supreme Court granted review in *Gillette*.

h. Briefs on the merits have been filed by the parties.

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.

11. Sourcing of Sales of Tangible Personal Property and Shipping Charges

    a. FTB Chief Counsel Ruling 2013-3

        (1) FTB ruled that sales of tangible personal property ultimately destined for another state but shipped to a third party public warehouse in California for temporary storage, pending shipment in the same form as received, to the ultimate destination stare were not sales within California for inclusion in the sales factor.

        (2) The goods were not used in California through activities such as warehousing and repackaging, since the goods were stored in California for a limited period of time and were shipped to the ultimate destination in the same form that they were received.

        (3) Moreover, since the ultimate destination was designated by the taxpayer at the time of the initial order and was separately billed to the buyer's division in the ultimate state of destination, the temporary storage in California was merely for purposes of further shipment elsewhere in the stream of interstate commerce.

    b. *Williams-Sonoma, Inc. & Subsidiaries*, SBE Case No. 519857 (Sept. 11, 2013)

        (1) In a letter decision, the SBE ruled that the taxpayer's receipts from shipping fees on goods sent to California customers were sourced to the taxpayer's sales factor numerator along with the gross receipts from the sale of those goods.

(2) The taxpayer's shipping services were not considered to be a separate income producing activity subject to the sourcing rules for sales of other than tangible personal property.

B. Distortion and Special Industry Formulas

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.

2. *Microsoft Corporation v. FTB*, 212 Cal. App. 4th 78 (2012).

   a. Suit for refund filed on January 22, 2008. 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. Taxpayer appealed issue (1) above. On December 18, 2012, the Court of Appeal reversed and held in favor of the taxpayer. The Court held that a license to replicate and install software programs in the manufacturing of computers constitutes intangible property. The licensing of software programs did not constitute California sales, because under the sourcing rules applicable to sales of intangibles, the greater proportion of the taxpayer's costs of performance related to such licensing were incurred in Washington.

3. 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.

b. *DTS, Inc.,* SBE Case No. 570576

(1) Case involved issue whether Regulation 25137-3 applied strictly to the licensing of trademarks, trade names and service marks as the FTB contended, or whether it also applied to the licensing of patented technology and know-how. Case settled in January 2014.

4. 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.

b. In Chief Counsel Ruling 2013-1, FTB ruled that a motion picture entertainment company that engaged in a process that transformed two- and three-dimensional films so that they may be displayed in a theater was a "producer" within the meaning of Regulation 25137-8.2. Thus, the revenue derived from such process was gross receipts from "films in release to theaters" assignable under the Regulation.

5. Occasional Sales

a. In *Emmis Communications Corp.*, SBE Case No. 547964 (June 12, 2013), the SBE determined in a letter decision that the gross receipts from a media company's sale of 13 television stations should be included in the sales factor, and should not be excluded as occasional sales under Regulation 25137(c)(1)(A).

b. In Chief Counsel Ruling 2014-02, the FTB concluded that the taxpayer's asset sales pursuant to a post-bankruptcy plan of reorganization were within the normal course of business and occurred at short intervals on a regular basis within a two-year period. Thus, the sales were not "occasional sales" within the meaning of Regulation 25137(c)(1)(A) and the resulting gross receipts should be included in the sales factor.

II. Credits

A. 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. *Pacific Coast Building Products, Inc.*, SBE Case No. 514183

   a. Case involved the following issues: (1) whether taxpayer presented sufficient evidence that its activities constituted qualified research, (2) whether taxpayer met its burden of proving qualified research expenses and (3) whether taxpayer substantiated its fixed-based percentage as required by IRC § 41(c)(3)(A).

   b. At the initial hearing, issues also were raised regarding the sufficiency of non-contemporaneous documentation and whether the documentation established "a process of experimentation" relating to each project.

   c. On October 29, 2013, another hearing was held before the SBE for further review of the "process of experimentation" issue.

   d. On February 25, 2014, the SBE issued a summary decision finding that the taxpayer demonstrated that its activities were qualified activities through contemporaneous and other documentation as

well as oral testimony. The SBE also ruled that taxpayer established, through such evidence, that it was engaged in a process of experimentation for substantially all of its research activities.

4. *DreamWorks Animation SKG, Inc.*, SBE Case No. 717701

   a. Case involved the issue of whether film production employees who were an integral part of the taxpayer's software development process performed qualified services as defined in IRC § 41.

   b. FTB conceded that production employees who were listed on patents performed qualified services.

   c. In October 2013, the case was dismissed upon request of the FTB, which granted the research credits in full.

5. 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.

6. On October 11, 2012, the FTB held an interested parties meeting 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.

7. In November 2013, FTB Chief Counsel Jozel Brunett indicated that the FTB generally will follow federal determinations on research credits where California law conforms to federal law. On March 24, 2014, FTB Tax Counsel Kristin Kane confirmed the same.

B. Enterprise Zone Hiring Credits

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

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

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

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

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. Case settled after remand to trial court.

3. *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.

4. On January 11, 2013, HCD proposed regulations that would prohibit retroactive vouchering in certain instances, tighten the vouchering process and create stricter audit procedures.

5. On July 11, 2013, Governor Brown approved AB 93, which creates new economic development incentives to replace the current EZ hiring credit.

   a. EZ hiring credits will be repealed on January 1, 2014.

      (1) No new EZ hiring credits may be generated for tax years beginning on or after January 1, 2014.

      (2) EZ hiring credits generated prior to January 1, 2014 may be carried forward for up to 10 years.

   b. New incentives beginning in 2014 (see Governor's Economic Development Initiative, Section II.C below).

   c. On September 26, 2013, the Governor also approved legislation to extend the time period to apply for vouchers for the EZ hiring credit.

C. Governor's Economic Development Initiative

1. California Competes Credit—Tax credits to retain or attract new business activity in California, to be administered by GO-Biz.

2. New Employment Credit—Targeted income and franchise tax hiring credit.

3. Sales and Use Tax Exemption—For purchases of manufacturing-related equipment.

D. 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." Assigned credits may be applied against the tax of the assignee in taxable years beginning on or after January 1, 2010. 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 Legislature clarified that any limitations on the allowance of a credit that would apply to the assigning taxpayer also applies to the assignee. See SBX1 28 (Sec. 8(a)).

c. 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.

d. On October 1, 2012 and December 5, 2013, the FTB held interested parties meetings 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.

e. On June 12, 2014, the FTB held a third interested parties meeting to discuss draft language for proposed regulations to address defective credit assignments under RTC § 23663.

E. 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.

c. On October 4, 2013, Governor Brown approved AB 1173, which permits the film tax credit to reduce tax below the tentative minimum tax, retroactively to January 1, 2011. See RTC § 23036(d)(1)(R).

d. On September 18, 2014, Governor Brown approved AB 1839, which increases the amount available for the film and television production credit and extends the credit to more types of projects.

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 business.

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 allowed a dividends received deduction for dividends from noninsurance companies that were present in California as determined by its apportionment factors. The Court held that such a limitation violated the Commerce Clause.

2. As a result of *Farmer Bros.*, the FTB announced that for years ending on or after December 1, 1999, no deduction would be allowed under RTC § 24402.

a. *Abbott Laboratories, et al. v. FTB*, 175 Cal. App. 4th 1346 (2009)

(1) 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.

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

(1) 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.

B. *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. The trial court rejected the FTB's application of the broad fungibility concept embodied in the foreign investment interest offset rules of Regulation 24344.

5. 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 V.B below.

6. Challenges to the application of the foreign investment interest offset rules under Regulation 24344 are pending before the FTB.

IV. Business/Nonbusiness Income

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

1. 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.

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

3. On March 6, 2014, the court ruled that the break-up fee was business income and that the evidence did not establish a unitary relationship. Judgment entered August 22, 2014.

B. *C.V. Starr & Affiliates v. FTB*, San Francisco Superior Court No. CGC-13-527952

1. On January 11, 2013, taxpayer filed suit regarding issue whether dividend and capital gain resulting from its acquisition and subsequent sale of AIG common stock is business or nonbusiness income.

2. Stipulation of Settlement was filed on May 29, 2014.

C. *Fidelity National Information Service Inc. v. FTB*, Sacramento Superior Court No. 34-2013-00148015

1. On July 15, 2013, taxpayer filed suit regarding issue whether gain from the sale of a minority stock interest is business or nonbusiness income.

2. Taxpayer also is challenging the constitutionality of the LCUP.

3. Case is pending at trial court.

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

1. 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.

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

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

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

5. 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.

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

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

2. 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).

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

1. 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.

2. 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.

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

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

1. 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.

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

1. 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.

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

1. 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. The parties agreed to go to mediation.

J. FTB Legal Ruling 2012-01

1. 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.

V. Water's Edge Election

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

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

2. 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.

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

1. California Court of Appeal held that the dividends from a controlled foreign corporation that was partially included in a water's edge combined report should be treated as paid first out of current year earnings and then

out of prior years' earnings, for purposes of determining whether such dividends should be eliminated under RTC § 25106 or deducted under RTC § 24402.

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

C. FTB Technical Advice Memorandum 2011-02

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.

VI. 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 was August 1, 2011 to October 31, 2011. RTC § 19761.

2. VCI 2 applied 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. Taxpayers participated 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 were allowed with respect to amounts paid under VCI 2.

b. Participating taxpayers agreed 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 applied.

4. Most penalties were 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) were not 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. FTB Notice 2008-4

1. 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.

C. FTB Notice 2011-01

1. 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.

D. FTB Notices 2011-03 and 2011-04

1. 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.

E. *Gonzales v. FTB,* California Court of Appeal, First Appellate District Case No. A134238 (April 30, 2013)

1. Taxpayer filed suit seeking a refund of California personal income taxes based on an alleged $142 million capital loss in an abusive tax shelter transaction. Taxpayer also filed a tax refund action in federal district court seeking a federal income tax refund due to disallowance of the same $142 million capital loss at issue in the California refund suit.

2. In March 2011, the federal district court granted summary judgment in favor of the federal government, concluding that the taxpayer had not submitted evidence creating a triable issue of fact on the issue whether the taxpayer entered into the transaction primarily for profit. In September 2012, the Ninth Circuit affirmed the district court's ruling.

3. The FTB filed a motion for judgment on the pleadings in the California refund suit, contending that the judgment in the federal action collaterally estopped the taxpayer from claiming a profit motive for the transaction. The trial court ruled that the taxpayer's California tax refund action failed as a matter of law.

4. In an unpublished decision, the Court of Appeal affirmed the trial court's ruling and concluded that collateral estoppel prevented the taxpayer from re-litigating certain issues in his California tax refund action that were decided in a federal action involving the same disputed transaction.

VII. **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 any one of 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.

   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. A "change of law" means:

      (1) A statutory change, or

      (2) An interpretation of law or rule of law by regulation or legal ruling, or

      (3) A published federal or California court decision.

      FTB is directed to implement the foregoing exception in a reasonable manner.

   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. California imposed a penalty for amounts "due and payable" for taxable years for which amnesty could have been requested (i.e., taxable years beginning before January 1, 2003). Amnesty was available during the two-month period from February 1, 2005 through March 31, 2005.

2. *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.

3. *River Garden Retirement Home v. FTB* (see Section III.A.2.b 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.

VIII. **Miscellaneous**

A. 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."

d. In September 2014, FTB announced that the inflation-adjusted threshold values for 2014 are $529,562 in California sales and $52,956 in California property or payroll.

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. FTB Technical Advice Memorandum 2012-01

a. FTB concluded that, for taxable years beginning on or after January 1, 2011, physical presence in the destination state is not required to establish that the taxpayer is subject to tax in that state, for purposes of avoiding sales throwback under RTC § 25135.

b. FTB also concluded that, for taxable years beginning before January 1, 2011, physical presence is required in the destination state to avoid throwback, because California's "economic nexus"

provisions under RTC § 23101(b) apply only to taxable years beginning on or after January 1, 2011.

4. FTB Chief Counsel Ruling 2012-07

   a. FTB concluded that the in-state presence and activities of a single employee of the taxpayer constituted "doing business" in California such that the taxpayer had sufficient nexus to be required to file California corporation franchise/income tax returns.

5. In Legal Ruling 2011-01, the FTB ruled that mere ownership of a disregarded entity creates California franchise tax nexus. See Section VIII.C.6 below.

6. In Legal Ruling 2014-01, the FTB ruled that a business entity is 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.

   a. Applies whether LLC is member-managed or manager-managed.

   b. Limits SBE decision in *Amman & Schmid* strictly to limited partners in a limited partnership.

7. *SUP, Inc.*, SBE Case No. 571262 (Nov. 14, 2012).

   a. In a summary decision, the SBE ruled that a Nevada corporation that was a general partner of a Nevada limited partnership that was doing business in California was considered to be doing business in California and, thus, was liable for the California minimum franchise tax.

8. *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.

   b. Case also involves issue whether FTB improperly discriminates against multistate unitary corporate taxpayers be requiring combined reporting and not allowing them to choose separate reporting. The court sustained FTB's demurrer regarding this issue. See also *Abercrombie & Fitch v. FTB*, Fresno Superior Court No. 12CECG03408.

   c. On May 1, 2013, the court ruled that the subsidiaries had nexus with the State and thus were taxable in California.

d. On June 27, 2013, the taxpayer filed a notice of appeal. The case is fully briefed and is awaiting oral argument.

9. *Daniel V, Inc. v. FTB*, Los Angeles Superior Court No. BC457301 (March 13, 2013)

a. The court found that the taxpayer, a Nevada corporation, established that it was commercially domiciled in Nevada, so the income at issue was not taxable in California. Court awarded attorney's fees to the taxpayer.

b. FTB filed a notice of appeal on June 17, 2013. On September 16, 2013, the case was dismissed upon FTB request.

10. *Swart Enterprises v. FTB*, Fresno County Superior Court No. 13CECG02171

a. Case involves issue whether a corporate taxpayer is doing business in California and subject to minimum tax solely through its ownership interest in a California limited liability company.

b. Trial is scheduled to commence on March 4, 2015.

11. *Mednax Services, Inc. v. FTB*, San Francisco Superior Court No. CGC-14-539294

a. Case involves issue whether FTB properly required the taxpayer to file combined income tax reports with other entities pursuant to RTC § 25102.

b. Under RTC § 25102, FTB may permit or require the filing of a combined report by persons "owned or controlled directly or indirectly by the same interests," where the combination is "necessary in order to reflect the proper income of any such persons."

c. Case also involves issue whether LCUP penalty was properly imposed where FTB is requiring combination under RTC § 25102.

d. Case is pending at trial court.

B. 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.

d. On September 19, 2014, the Nevada Supreme Court upheld the jury verdicts on Hyatt's fraud and intentional infliction of emotional distress claims.

(1) The Court reversed the punitive damages award ($250 million) on the basis that Nevada does not authorize punitive damages against a government entity, which, under comity principles, extends to the FTB.

(2) Case remanded to the trial court to determine the proper amount of damages attributable to the intentional infliction of emotional distress claim.

e. While the Nevada case was pending, Hyatt filed suit in federal district court on April 4, 2014 alleging that the FTB and SBE have violated his due process and equal protection rights by taking more than 20 years to complete the administrative process in his California personal income tax dispute.

(1) SBE case currently pending regarding residency and source of income issues.

3. See *Daniel V* at Section VIII.A.9 above.

4. See *Cutler* at Section VIII.F.1 below.

C. Limited Liability Company Issues

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

   a. The Court of Appeal held that California's LLC fee under RTC § 17942 violates the Commerce and Due Process Clauses because it is based on worldwide gross income and not apportioned between gross income sourced within and without California.

   b. The LLC at issue 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. 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. At issue was an LLC that had approximately 10 percent of its revenues from California sources. 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.

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. Issue regarding the denial of class certification is on appeal.

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. Issue regarding the denial of class certification is on appeal.

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.

   c. On December 21, 2012, the trial court entered judgment in favor of the FTB. On February 12, 2013, a notice of appeal was filed. Case has been fully briefed on the merits.

   d. On March 20, 2014, the Court of Appeal asked taxpayer to address whether a final judgment from which taxpayer could appeal exists in this case. On April 1, 2014, taxpayer filed a letter in response.

6. FTB Legal Ruling 2011-01

   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).

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.

c. In October 2013, FTB issued a 15-day change notice to clarify certain proposed amendments and provide that, while the DISA proposed amendments are retroactive, taxpayer can elect to apply such amendments prospectively.

d. The proposed amendments were approved and became effective on April 1, 2014.

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 Chief Counsel Ruling 2012-08

a. The FTB ruled that dividends paid to a newly formed unitary holding company should be eliminated from the holding company's income under RTC § 25106(a)(2)(A), even though the holding company was formed subsequent to the generation of the income from which the dividends were paid, provided that the holding company was part of the unitary group during the period from its formation to its receipt of those dividends.

4. Regulation 25137-1

   a. The FTB held a second interested parties meeting on October 18, 2013 to discuss possible amendments to Regulation 25137-1. Issues include the sales factor treatment of intercompany sales between a partner and its unitary partnership and the treatment of distributive share items from a non-unitary partnership. The first interested parties meeting was held on August 21, 2008.

   b. On July 8, 2014, a third interested parties meeting was held to discuss draft language for proposed regulations.

E. Federal Conformity

1. IRC § 355 transactions

   a. In FTB Chief Counsel Rulings 2009-01 and 2009-02, 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. Treas. Reg. § 1.337(d)-2

   a. In FTB Chief Counsel Ruling 2012-06, the FTB concluded that Treas. Reg. § 1.337(d)-2 would not operate for California purposes to disallow a deduction for certain worthless stock losses attributable to members of a combined reporting group.

   b. While California generally conforms to Subchapter C (including IRC § 337), the FTB reasoned in CCR 2012-06 that Reg. § 1.337(d)-2 is essentially a federal consolidated return provision since it applies only to taxpayers that file federal consolidated returns. Because California does not generally conform to the federal consolidated returns, the FTB concluded that Reg. § 1.337(d)-2 is not applicable for California purposes.

F. Qualified Small Business Stock ("QSBS")

1. On August 28, 2012, the Court of Appeal held in *Cutler v. FTB*, 208 Cal. App. 4th 1247 (2012), that California's deferral of capital gain from the sale of QSBS 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.

a. The trial court denied taxpayer's motion for attorney's fees.

b. On September 2, 2014, the Court of Appeal reversed the trial court and awarded attorney's fees as a private attorney general. Case was remanded to determine the amount of the fees.

2. On December 21, 2012 and in response to *Cutler*, the FTB issued Notice 2012-03 to inform taxpayers that, for tax years beginning on or after January 1, 2008, the FTB will disallow all California QSBS exclusions and deferrals under RTC §§ 18038.5, 18152.5. FTB's position is that California's QSBS statutes are invalid and unenforceable in light of *Cutler*. FTB announced that it will be issuing proposed assessments back to 2008.

3. On October 4, 2013, Governor Brown approved AB 1412, which re-enacted the QSBS gain deferral and exclusion provisions retroactively for tax years 2008 to 2012, by removing the California presence requirements that the *Cutler* Court held to be unconstitutional.

a. Note that under AB 1412, the QSBS must meet the 80-percent California payroll requirement at the time of acquisition. Query whether such requirement is constitutional under the Commerce Clause.

G. Net Operating Loss (NOL)

1. NOL Carryback

a. California now allows a two-year carryback of NOLs attributable to taxable years beginning on or after January 1, 2013. RTC §§ 24416.21, 24416.22.

b. The suspension of NOL deductions for 2008-2011 (see below) does not apply to the carryback of NOLs attributable to taxable years beginning on or after January 1, 2013. RTC § 24416.21(c).

2. NOL Suspension

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

b. The suspension of NOL deductions was extended 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.

H. Investment Partnerships

1. 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.

2. "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.

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

4. 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.

5. In Chief Counsel Ruling 2013-4, the FTB ruled that a nonresident member of an LLC that provided management services to a private equity fund located in California was subject to California personal income tax on the income, even though the private equity fund was a qualified investment partnership.

I. Procedural Issues

1. SBE Written Opinions

a. Effective January 1, 2013, the SBE is required to issue written decisions within 120 days of deciding tax appeal cases, including franchise and income tax appeals, when the amount in controversy is $500,000 or more. See RTC § 40.

b. The SBE announced that it will narrowly draft its written decisions to comply with the new law.

J. Nonwage Withholding

1. Beginning July 1, 2013, the FTB implemented an ongoing Withholding Voluntary Compliance Program (WVCP) for eligible withholding agents (businesses and individuals) to remit past-due, nonwage withholding for the previous two calendar years (look-back period), plus interest.

   a. All withholding agents are eligible, except if the withholding agent (i) participated in the 2008 Nonresident Withholding Incentive Program, (ii) has been audited by FTB for nonwage withholding or (iii) has been assessed a withholding liability or information return penalty for nonwage withholding.

2. The FTB revised and updated its withholding at source regulations (Regulations 18662-0 through Regulations 18662-14) to conform to current withholding laws and existing FTB procedures. The Regulations took effect on July 1, 2014.

IX. Legislative Updates and Ballot Measures

A. 2012 and 2013 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 IX.C.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 to publish written formal opinions. See Section VIII.I.1 above.

4. AB 93 (July 11, 2013)

a. Economic development incentives enacted to replace the current California Enterprise Zone tax credits. See Section II.B.5 above.

5. AB 1173 (October 4, 2013)

a. State's film tax credit permitted to reduce tax below the tentative minimum tax, effective retroactively to January 1, 2011. See Section II.E.1.c above.

B. 2014 Legislative Session

1. On June 20, 2014, the 2014-15 state budget was approved, which included some additional fees but no major broad-based tax increases.

2. AB 1839 was signed into law, expanding the film and television production credit. See Section II.E.1.d above.

3. SB 1335 was signed into law, requiring that new income and corporate tax credits enacted after January 1, 2015 set performance measures and goals.

4. SB 1372 was introduced which would increase the corporation tax rates on publicly held corporations that pay their chief operating officer or highest paid employee more than 100 times the median compensation of all employees. SB 1372 did not gain passage in the Senate.

C. Election Results of November 2010 Ballot Measures of Note

1. Proposition 24

a. Voters rejected 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

a. 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

a. 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.

b. 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.

D. Election Results of November 2012 Ballot Measures of Note

1. Proposition 30

a. Voters approved a measure to increase the state sales and use tax by 0.25 percent. The increase will be in effect from January 1, 2013 through December 31, 2016. The measure also increased the personal income tax rate for the 2012-2017 taxable years for taxpayers with taxable income exceeding $250,000.

2. Proposition 31

a. Voters rejected a measure to prohibit legislation, including the Governor's budget, that would reduce taxes by $25 million or more, unless another tax is increased or funding for an existing program is reduced or eliminated.

3. Proposition 38

a. Voters rejected a measure to 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

a. Voters approved a measure to eliminate the single-sales factor election and require most businesses to use a single-sales factor apportionment formula to determine California business income for taxable years beginning on or after January 1, 2013.

b. In addition, Proposition 39:

(1) Requires the use of the market-based sourcing rules for sales of intangibles and services for all taxpayers, including agricultural, extractive and financial businesses; and

(2) Provides for a modified sales factor sourcing rule for certain cable businesses that make at least $250 million of annual expenditures in California.

c. See Section I.A.4 above.

Sales and Use, Property and Other Taxes

X. **Sales and Use Tax**

A. Technology Transfer Agreements

1. 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.

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

3. 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.

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

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

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

7. On January 15, 2013, the SBE Business Taxes Committee approved staff's recommendation to continue to work with interested parties.

8. *Lucent Technologies, Inc. v. State Board of Equalization* (Case No. BC402036).

   a. On September 27, 2013, a Los Angeles superior court granted taxpayers' motion for summary judgment regarding issue whether the sale of software qualifies as a TTA exempt from sales tax.

   b. Court followed *Nortel* under nearly identical facts.

   c. On April 18, 2014, court awarded $2.6M in attorney's fees.

B. Online Retailers

1. 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):

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

   b. Any retailer that is (i) a member of a commonly controlled group, (ii) and is also a member of a unitary combined reporting group for California income/franchise tax purposes and (iii) 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

   c. 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.

2. 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.

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

4. Regulation 1684 Amended

   a. 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.

   b. 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.

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

C. 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.

D. Reallocation of Local Tax under Uniform Sales and Use Tax Law

1. *Petition of City of Fillmore*, SBE Case No. 466375 (Aug. 13, 2013)

   a. The SBE concluded that sales between the taxpayer and its parent occurred outside California, where title passed from taxpayer to its parent outside the State, at the time and place of shipment, since the sale agreement did not include an F.O.B. destination provision or expressly require that the taxpayer deliver at Parent's California destination. Thus, taxpayer incorrectly reported the local tax as sales tax to Fillmore.

   b. The SBE also concluded that the taxpayer's Fillmore office was not a business location that participated in the sales, and thus, the taxpayer incorrectly reported the local tax as sales tax to Fillmore.

2. *Petition of City of Fillmore*, SBE Case No. 626418 (Sept. 23, 2014)

   a. The SBE concluded that local sales tax was correctly allocated to Fillmore on sales that were principally negotiated by taxpayer's California employees who primarily work in the field or in their homes. Such employees were assigned to work out of taxpayer's

Fillmore office, for which taxpayer was required to hold a seller's permit.

3. *Petitions of Cities of Agoura Hills, et al.*, SBE Case No. 469672 (Nov. 14, 2012)

   a. The SBE concluded that a seller's permit may be issued to a "buying company" provided it satisfies the general requirement that the permit be issued for a place of business where the entity engages in business as a seller of tangible personal property.

   b. The SBE also concluded that where sales of tangible personal property were delivered from the taxpayer's California warehouses, the local sales tax was properly allocated to those locations.

4. *City of Palmdale v. SBE*, 206 Cal. App. 4th 329 (2012)

   a. In a local sales/use tax collection case, the Court issued a scathing rebuke of the SBE's procedures in local tax matters and refused to allow a settlement by the parties.

   b. The Court stated that "[t]his appeal deserves particular attention because, according to the judgment, the Board displayed repeated lack of concern for the statutory and constitutional procedures that restrict its decision-making authority."

E. Class Action Lawsuits for Improper Collection of Sales and Use Tax

1. *Loeffler v. Target Corp.*, 173 Cal. App. 4th 1229 (2009)

   a. Court of Appeal held that consumers are barred by the California Constitution and state laws from asserting class action claims against retailers for alleged improper collection of sales tax.

   b. On May 1, 2014, the California Supreme Court affirmed.

2. *Yabsley v. Cingular Wireless*, 176 Cal. App. 4th 1156 (2009)

   a. Court of Appeal affirmed a judgment dismissing an action against a cellular service provider for charging sales tax on the full sale price of a cellular phone even though the phone was sold for half price when purchased with a service plan.

   b. On July 9, 2014, the California Supreme Court dismissed review and remanded to Court of Appeal in light of *Loeffler* decision above.

F. SBE Regulations

1. Regulation 1502.

a. Effective July 1, 2014, Regulation 1502 was amended to clarify that sales tax applies to 50 percent of the lump-sum charge for optional maintenance contracts that include a backup copy of a prewritten program recorded on tangible storage media.

b. The 50 percent charge also applies to such contracts even if paired with a nontaxable electronic download and load-and-leave transaction.

2. Proposed Regulation 1525.4

a. On July 17, 2014, the SBE held a public hearing on a proposed regulation relating to exempt qualified purchasers of manufacturing or R&D equipment under the new sales tax exemption, effective July 1, 2014 (see Section II.C.3 above).

b. On August 14, 2014, the proposed regulation was submitted to the Office of Administrative Law for approval.

3. Regulation 1705

a. Effective July 1, 2014, Regulation 1705 was amended to extend relief from liability to persons who reasonably relied on written advice of the SBE that was provided in a prior audit of a related person.

XI. **Property Tax**

A. *Elk Hills Power, LLC v. California State Board of Equalization*, 57 Cal. 4th 593 (2013)

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

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

3. On August 12, 2013, the California Supreme Court reversed and held that the SBE cannot include the value of intangibles when assessing property.

B. *Western States Petroleum Association v. SBE*, 57 Cal. 4th 401 (2013)

1. 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.

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

3. On August 5, 2013, the California Supreme Court held that Rule 474 is consistent with Proposition 13 and California statutes. However, the Court affirmed the judgment of the Court of Appeal invalidating Rule 474 because of the SBE's failure to make an adequate initial determination of the rule's economic impact as required by the Administrative Procedures Act.

C. *EHP Glendale, LLC v. County of Los Angeles*, California Court of Appeal, Second Appellate District, Case No. B244494 (2013).

1. On September 18, 2013, the Court of Appeal held that substantial evidence supported the findings of the local county board of assessment appeals for its assessment of a California hotel's property following sale of the hotel and the board's deduction of certain intangible property from the income stream of the property.

2. On December 18, 2013, the California Supreme Court denied review and decertified the Court of Appeal opinion.

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

1. 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.

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

1. 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.

F. *Ocean Avenue LLC v. County of Los Angeles*, Cal. Ct. App., Second App. Dist. Case No. B246499 (2014)

1. On June 3, 2014, the California Court of Appeal affirmed the trial court, holding that even though 100 percent of an entity was sold, a reassessable change in ownership of the entity's real property did not occur, where no one person obtained more than 50 percent of the entity.

2. On September 10, 2014, the California Supreme Court denied review.

G. 2011-2012 Proposed Legislation

1. 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.

2. 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.

H. 2013-2014 Proposed Legislation

1. Assembly Bill No. 2372 (AB 2372)

a. AB 2372 would broaden the definition of "change in ownership" for purposes of property tax reassessments.

b. AB 2372 would change the result reached in *Ocean Avenue* for entity transfers occurring on or after January 1, 2015. AB 2372

would provide that a change in ownership occurs when cumulatively 90 percent or more of the ownership interests in an entity are transferred in a 3-year period, even if no one owner obtains more than 50 percent.

c. AB 2372 was sent to the suspense file and is not expected to advance this year.

2. Senate Bill No. 1021 (SB 1021) would have allowed school districts to create a split roll at the local level by imposing a parcel tax on property used for commercial as opposed to residential purposes. SB 1021 failed passage in the Assembly Revenue and Taxation Committee.

XII. Local Taxes

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

1. 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.

B. *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 (Jan. 9, 2012)

1. 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.

2. 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.

3. On January 9, 2012, the trial court issued a statement of decision reversing the Review Board. The trial court's decision was not appealed.

C. *926 North Ardmore Avenue, LLC v. County of Los Angeles*, Cal. App. Ct., Second App. Dist., Case No. B248536 (Sept. 22, 2014)

1. Court held that the transfer of more than 50 percent of a partnership's interest in an LLC that held title to realty was a "change of ownership" subject to documentary transfer tax.

2. For transfer tax purposes, Court applied property tax definition of a "change of ownership," which includes ownership changes of realty as well as legal entities.

D. San Francisco Gross Receipts Tax

1. In November 2012, San Francisco voters approved a local measure that would phase out San Francisco's current payroll tax and implement an apportioned gross receipts tax beginning in 2014.

   a. The gross receipts tax identifies various industry groupings, each of which has specific tax rate schedules and allocation and apportionment methodologies.

   b. Combined reporting generally is required.

2. City is in the process of drafting instructions and other guidance to implement the new law. No regulations are contemplated.

3. A proposed ordinance is pending which would amend the business tax provisions, including: 1) revising the minimum filing amounts for the payroll expense tax and gross receipts tax; 2) clarifying penalty and interest provisions; and 3) clarifying that each member of a combined group engaged in business in San Francisco must register with the Tax Collector.

E. *Schmeer v. County of Los Angeles*, 213 Cal. App. 4th 1310 (2013)

1. County ordinance requiring stores to charge customers ten cents for each paper bag was upheld as not a tax violating Proposition 26 (see Section IX.C.3 above).

F. Los Angeles Tax Amnesty Program

1. A tax amnesty program is available from September 1, 2013 through December 2, 2013 for the business tax, utility users tax and transient occupancy tax.