



# CALIFORNIA UPDATE

Financial Institutions State Tax Coalition  
Annual Meeting  
November 13, 2014

*Jeffrey M. Vesely*  
*Pillsbury Winthrop Shaw Pittman LLP*

# AGENDA

APPORTIONMENT

BUSINESS/NONBUSINESS

DIVIDENDS/INTEREST ADDBACK

CREDITS

NEXUS

SALES/USE TAXES

LOCAL TAXES

# APPORTIONMENT/SALES FACTOR

- Treasury Function Activities
  - *Microsoft Corporation v. FTB*, 39 Cal. 4<sup>th</sup> 750 (2006)
    - Gross proceeds from treasury function activities includable in sales factor
    - FTB sustained burden of proof that the inclusion of gross receipts from treasury function activities created a distortion under Revenue and Taxation Code (“RTC”) § 25137
    - Qualitative and quantitative distortion held to exist

# APPORTIONMENT/SALES FACTOR

- Hedging Activities

- *General Mills v. FTB*, 172 Cal. App. 4<sup>th</sup> 1535 (2009) (*General Mills I*)
  - Hedging transactions found to be integral to taxpayer's core business
  - Receipts from hedging activities includable in sales factor
  - Distortion issue not addressed
  - Case remanded to address distortion issue
- *General Mills v. FTB*, 208 Cal. App. 4<sup>th</sup> 1290 (2012) (*General Mills II*)
  - On remand, court held that notwithstanding *General Mills I*, taxpayer's hedging activities were qualitatively different from its main business
  - An 8.2 percent difference in California net income was held to be sufficient quantitative distortion to invoke RTC § 25137

# APPORTIONMENT/SALES FACTOR

- Broker-Dealer Activities

- If a broker-dealer is unitary with a bank should the broker-dealer's gross receipts be included in the sales factor?
- This is a very active and controversial issue
- A number of cases are pending or have been settled
- What is the effect of *Merrill Lynch* (1989)?
- What is the effect of *Fuji Bank* (2000)?
- FTB has been considering some type of administrative action in this area

# APPORTIONMENT/SALES FACTOR

- Broker-Dealer Activities, cont.
  - What is the effect of Regulation 25137(c)(1)(D)?
    - Applicable for tax years beginning on or after January 1, 2007
    - Broker-dealers not considered to be performing a treasury function
  - What is the effect of RTC § 25120(f)(2)?
    - Applicable for tax years beginning on or after January 1, 2011
    - Treasury function does not include trading activities of a registered broker-dealer
  - May a bank which has a broker-dealer subsidiary use a double-weighted sales factor after 1993?
  - May a bank make a single sales factor election for 2011-2012?

# APPORTIONMENT/SALES FACTOR

- Broker-Dealer Activities, cont.
  - May a bank be required to use a single sales factor apportionment formula for 2013?
  - RTC § 25128(b) looks to whether a unitary business derives more than 50 percent of its gross receipts from banking and financial activities.
    - If the receipts are excluded from the sales factor under RTC § 25137, they are still considered for purposes of RTC § 25128(b)

# APPORTIONMENT/SINGLE SALES FACTOR

- Single Sales Factor Election
  - Tax Years 2011-2012
  - Irrevocable annual election
  - Not available to taxpayers listed in RTC § 25128(b)
  - Taxpayers making election required to use market-based sourcing
  - Cost of performance still required if no election



# APPORTIONMENT/MANDATORY SINGLE SALES FACTOR

- Mandatory Single Sales Factor
  - Applies for tax years beginning on or after January 1, 2013
  - Only taxpayers listed in RTC § 25128(b) not affected
  - Market-based sourcing required
  - No cost of performance allowed for any taxpayer

# APPORTIONMENT/SOURCING OF SALES

- Market-based sourcing of sales of services and intangibles
  - Required for tax years beginning on or after January 1, 2011
  - Regulation 25136-2 contains elaborate set of cascading rules
  - Services sourced to the state where purchaser receives the benefit of the services
  - Intangibles sourced to the state where the intangible property is used
  - Sales factor provisions of Regulations 25137-25137-14 (including Regulation 25137-4.2) are incorporated to reflect market-based sourcing
    - No throwback required
  - Additional issues being addressed in the regulatory process

# APPORTIONMENT/SOURCING OF SALES

- *Finnigan* returns yet again
  - Only sales of tangible personal property
  - Tax Years 2011 and thereafter

# APPORTIONMENT/SOURCING OF SALES

- Regulation 25137-3 (Franchisors)
  - Chief Counsel Ruling 2010-2
    - Applies to licensing of trademarks to licensees who also market products bearing the trademark
  - *DTS, Inc.*, SBE No. 570576

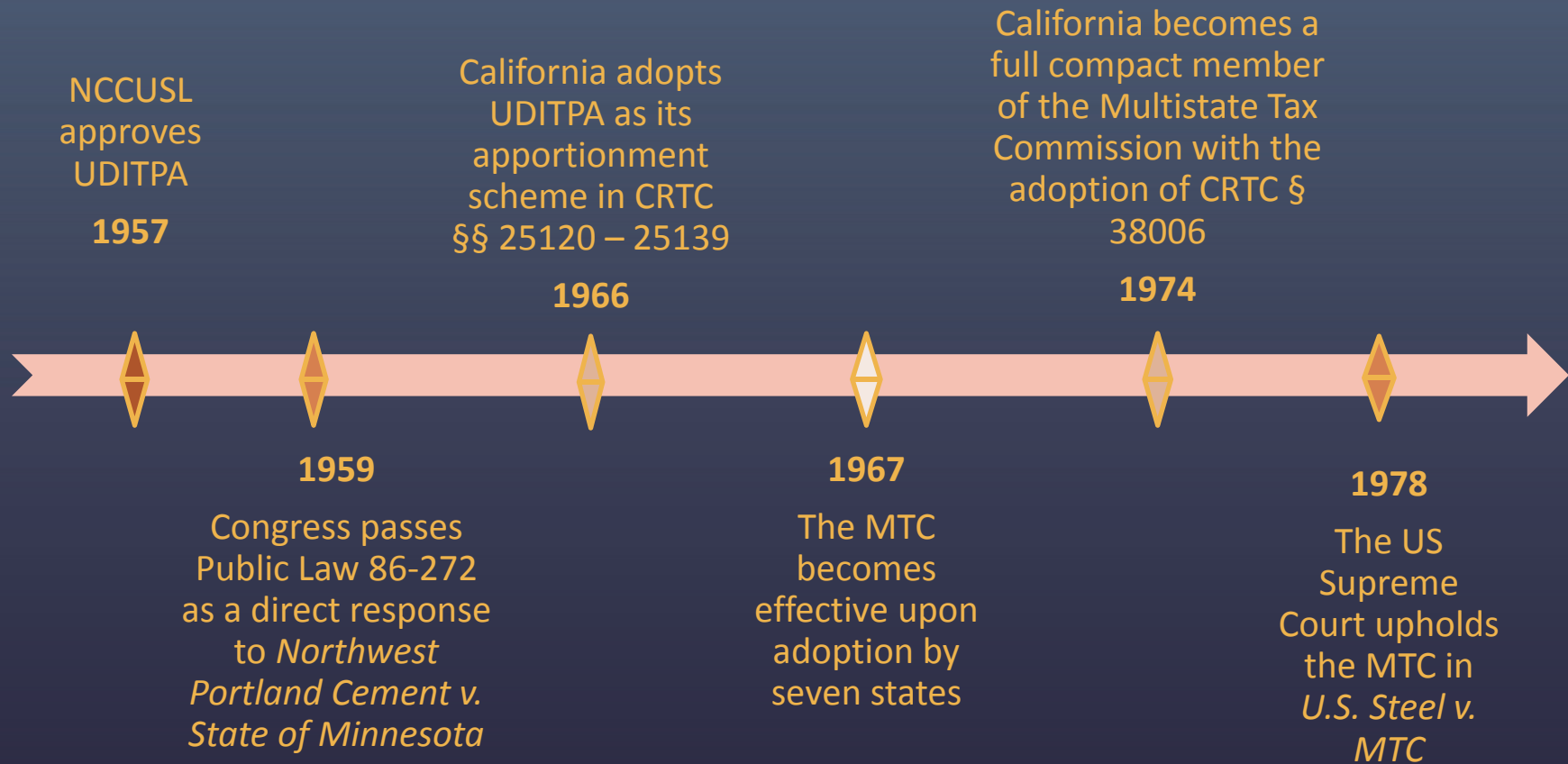
# APPORTIONMENT/SOURCING OF SALES

- Impact of New Economic Nexus Standard on Throwback Sales
  - Doing business definition expanded for tax years beginning on or after January 1, 2011
  - Chief Counsel Ruling 2012-03
    - Economic nexus standard will be applied for tax years beginning on or after January 1, 2011
  - TAM 2012-01
    - Physical presence not required in destination jurisdiction for tax years beginning on or after January 1, 2011

# APPORTIONMENT/MTC COMPACT

- *Gillette v. FTB, et al.*, 209 Cal. App. 4<sup>th</sup> 938 (2012)
  - May a taxpayer elect to use the three-factor apportionment formula under the MTC Compact, rather than the double-weighted sales factor apportionment formula?
  - Trial court granted demurrer
  - Court of Appeal reversed and held Compact was binding on California and superseded RTC § 25128 which was enacted in 1993
  - On January 16, 2013, California Supreme Court granted review

# CALIFORNIA TIMELINE



# CALIFORNIA TIMELINE

CA Adopts  
“Hyper  
Weighted” /  
Four Factor  
Formula

**1993**

CA AG Opines – MTC  
Membership Dues  
Mandatory until  
withdrawal from  
Compact

**1997**

Gillette Files  
Suit after denial  
of Refund  
Claims by FTB  
**January 2010**

**1995-96**

Budget Control  
Language  
Conditioning CA MTC  
Membership on MTC  
adopting Open  
Meetings Act

**2006**

Gillette Files  
Amended Returns /  
Claims for Refund  
for TY 1997 – 2004  
Claiming 3-Factor

**October 26, 2010**

Trial Court  
sustains FTB  
Demurrer in  
Gillette



# CALIFORNIA TIMELINE



# BUSINESS / NONBUSINESS INCOME

- *ComCon Production Services v. FTB*, LASC No. BC 489779 (2014)
  - Trial court held that termination fee from a failed merger was business income
  - Trial court also held that Comcast and QVC were not engaged in a unitary business
- *Levi Strauss*, SBE No. 54705
  - SBE appeal involving issue whether interest and other expenses incurred in connection with a leveraged buy out of a California corporation's stock were nonbusiness expenses wholly allocable to California
  - Case settled prior to the SBE hearing

# DIVIDENDS & INTEREST EXPENSE DEDUCTION/ADDBACK

- *Apple, Inc. v. FTB*, 199 Cal. App. 4<sup>th</sup> 1 (2011)
  - LIFO ordering of dividends required for purposes of RTC § 25106
  - Interest expense deductions not disallowed under RTC § 24425
  - Impact on foreign investment interest offset
  
- *Beneficial New Jersey, Inc. v. Director, Div. of Taxation*, CCH NJ Tax Rptr. ¶ 401-530 (2010)
  - Interest paid to parent finance company met “unreasonable exception” and not subject to addback

# CREDITS/RESEARCH & DEVELOPMENT

- Research credit is area of increased focus following expiration of the MIC and unfavorable EZ credit precedents
- FTB has created a specialist team and is conducting general audit training in this area
- Key areas of focus:
  - Challenging QREs on various grounds, including re-audit of federal audit results where FTB is not satisfied with degree of IRS audit scrutiny
  - QRE geography, especially contract research component
  - Separate audit of CA base period computation
  - Summarily disallowing any “pre-packaged study” for lack of contemporaneous documentation

# CREDIT/RESEARCH & DEVELOPMENT

*Pacific Coast Building Products, Inc.*, SBE No. 514183 (Feb. 25, 2014)

- Issues – (1) did taxpayer conduct qualified research; (2) did taxpayer prove qualified research expenses; (3) did taxpayer substantiate its fixed-based percentage as required by IRC § 41(c)(3)(A)
- Two oral hearings
- In a summary decision, the SBE found that:
  - The taxpayer demonstrated that its activities were qualified activities through contemporaneous and other documentation as well as oral testimony
  - The taxpayer established a nexus between the qualified research and a substantial portion of the claimed expenses

# CREDIT/RESEARCH & DEVELOPMENT

*DreamWorks Animation SKG, Inc.*, SBE No. 717701 (2013)

- Whether film production employees who were an integral part of the taxpayer's software development process performed qualified services as defined in IRC § 41.
- FTB conceded that employees in the R&D department and employees in the production department who were listed on patents performed qualified services.
- After the filing of appellant's opening brief and several discussions between the parties, the FTB conceded the case.

# CREDIT/RESEARCH & DEVELOPMENT

- In June 2011, FTB issued Legal Division Guidance (“LDG”) 2011-06-01
  - Purely service company with no “gross receipts” from sales of tangible personal property could not claim the R&D credit
- In July 2011, LDG 2011-06-01 withdrawn
- In March 2012, FTB issued LDG 2012-03-01
  - Taxpayers with no “gross receipts” under RTC § 23609(h)(3) can claim the R&D credit

# CREDIT/RESEARCH & DEVELOPMENT

FTB somewhat following federal determinations

- In November 2013, FTB Chief Counsel indicated that the FTB generally will follow federal determinations on research credits where California law conforms to federal law
- In its December 2013 issue of *Tax News*, the FTB confirmed that in order to improve and streamline R&D cases, if the IRS audited the R&D credit, the FTB will generally follow the federal determination. However, the FTB may need to request information to determine how to apply the IRS analysis to California research.



# CREDITS/GOVERNOR'S ECONOMIC DEVELOPMENT INITIATIVE

- Elimination of Enterprise Zone Hiring Credit
- Creation of:
  - California Competes Credit
  - New Employment Credit
  - Partial Manufacturing Sales and Use Tax Exemption

# CREDIT UTILIZATION LIMITATIONS

- In 2006, the California Supreme Court held in *General Motors v. FTB*, that research credits are entity specific within combined groups and may not offset tax liability of other group members – But see Credit Assignment discussed below
- AB 1452 caps the amount of business tax credits that can be claimed to 50% of the taxpayer's liability for taxable years beginning on or after January 1, 2008 and before January 1, 2010. (i.e. Credits can reduce tax liability by a maximum of 50%.)
- Credit limitation is on an entity by entity basis
- The amount of the credit disallowed because of the 50% limit will be allowed as a carryover
- The carryover period for any credit not allowed will be increased by the number of taxable years the credit is not allowed

# CREDIT ASSIGNMENT

- Under RTC § 23663 for tax years beginning on or after July 1, 2008, any “eligible credit” may be assigned to any “eligible assignee”
  - “Eligible credit” means any credit earned on or after July 1, 2008, as well as any credit earned prior to July 1, 2008, that is eligible to be carried forward to the first tax year beginning on or after July 1, 2008
  - “Eligible assignee” means any affiliated corporation properly treated as a member of the same unitary group
- A credit assigned may be applied only by an eligible assignee against its tax liability in tax years beginning on or after January 1, 2010

# CREDIT ASSIGNMENT

- Credits earned before July 1, 2008 may be shared if the assignee was unitary with the assigning corporation as of:
  - June 30, 2008, and
  - The last day of the tax year for which credits were assigned
- Note:
  - Assignee sold prior to the last day of combined group's tax year will not qualify
  - If not instantly unitary as of the end of the year, will not qualify
  - Cannot share pre-July 1, 2008 credits with companies acquired and unitary on or after July 1, 2008

# CREDIT ASSIGNMENT

- Payments to purchase credits
  - Are not deductible by the payor, and
  - Are not income to the recipient
- Both parties are liable for any tax, so if the FTB loses statute on one party it can still collect against the other
  - May want a tax sharing agreement
- An election to assign credit is irrevocable once made
- Taxpayer assigning credit shall reduce the amount of its unused credit and the amount is no longer included as a carryover

# CREDIT ASSIGNMENT

- Do not need to assign the entire amount of credits available. Taxpayer can retain carryover balance and decide later whether and to which entity to assign additional credits
- The assignee may not sell or otherwise transfer the assigned credit to any other taxpayer
- The election and assignment is made on FTB Form 3544, Election to Assign Credit Within Unitary Group
- Regulations are being promulgated

# NEXUS/DOING BUSINESS

- Under RTC § 23101, “doing business” expanded for tax years beginning on or after January 1, 2011
  - Economic nexus
  - Factor-based presence
    - Sales in California exceed lesser of \$500K or 25% of taxpayer’s total sales
    - Real property and tangible personal property in California exceeds lesser of \$50K or 25% of taxpayer’s total property
    - Payroll in California exceeds lesser of \$50K or 25% of taxpayer’s total payroll

# NEXUS/DOING BUSINESS

- Legal Ruling 2014-01
  - Business entity held to be doing business in California merely by holding a membership interest in an LLC that is doing business in California
- *Harley Davidson v. FTB*, SDSC No. 37-2011-00100896
  - Case involves issue whether certain special purpose entities are taxable in California
  - Case potentially raises issue of applicability of the immunity provisions for foreign lending institutions under Corporations Code § 191(d)



# SALES/USE TAXES

- Technology Transfer Agreements
  - *Nortel Networks Inc. v. SBE*, 191 Cal. App. 4<sup>th</sup> 1259 (2011)
    - Software licensed by taxpayer to operate switching equipment exempt from sales/use tax under statutes regarding technology transfer agreements
  - *Lucent Technologies, Inc. v. SBE*, LASC No. BC 402036 (2013)
    - Trial court ruled for taxpayer and followed *Nortel*
    - Attorneys fees awarded in the amount of \$2.6 million
  - SBE staff looking at how best to estimate the tangible personal property sold with a technology transfer agreement

# LOCAL TAXES (SALES/USE)

- *City of Palmdale v. SBE*, 206 Cal. App. 4th 329 (2012)
  - Local sales/use tax allocation case in which the Court issued a scathing rebuke of SBE's procedures in local tax matters and refused to allow a settlement by the parties
  - "This appeal deserves particular attention because, according to the judgment, the Board displayed a repeated lack of concern for the statutory and constitutional procedures that restrict its decision-making authority."

# CALIFORNIA LOCAL TAXES (CITY)

- *Chevron v. City of Richmond*, Contra Costa Superior Court, No. C09-00491 (2009)
  - Trial court invalidated the City's business tax under the internal consistency test
- *The Roman Catholic Archbishop of SF v. City and County of SF*, SFSC, No. CGC10498795
  - Trial court concluded that the transfer of 232 properties within the Archdiocese in an internal restructuring was not subject to the documentary transfer tax
- *926 North Ardmere Avenue LLC v. County of Los Angeles*, \_\_\_\_ Cal. App. 4<sup>th</sup> \_\_\_\_ (2014)
  - On September 22, 2014, Court of Appeal held that the documentary transfer tax applies to legal entity changes in ownership
- New Gross Receipts Tax in San Francisco
  - Being phased in for tax years beginning on or after January 1, 2015
  - Worldwide/water's edge unitary tax at the local level

# Questions

Jeffrey M. Vesely  
Pillsbury Winthrop Shaw Pittman LLP  
San Francisco  
[jeffrey.vesely@pillsburylaw.com](mailto:jeffrey.vesely@pillsburylaw.com)  
(415) 983-1075