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CALIFORNIA

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Franchise and Income Tax

I. Apportionment Formula

A. Sales Factor

1. 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 RTC § 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. FTB Tax News, April 2013.

2. 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.

3. 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.

e. Proposed amendments were issued on August 7, 2015 and a public hearing was held on September 22, 2015. As a result of the hearing, the FTB recommended changes to the proposed amendments.

f. On September 15, 2016, the amendments to Regulation 25136-2 were formally approved.

g. On January 20, 2017 and June 16, 2017, the FTB held first and second interested parties meetings to consider further amendments to address:

(1) asset management fees

(2) dividends

(3) government contracts

(4) R&D contracts

(5) freight-forwarding

(6) reasonable approximation standard

h. On March 29, 2017, the FTB issued Notice 2017-02 to provide procedures for requesting relief from the penalty for late payments attributable to compliance with new amendments to Regulation 25136-2.

i. On May 18, 2018, the FTB held a third interested parties meeting to discuss new draft language to clarify assignment of services and intangibles.

j. FTB Chief Counsel Ruling 2015-3

(1) Under RTC § 25136 and Regulation 25136-2, sales of non-marketing services are assigned to California to the extent the taxpayer's customers—and not its customer's customers—receive the benefit of the service in California.

(2) Taxpayer may use Central Processing Unit data as a reasonable proxy to determine the location and extent of

the benefit of the service received by the customers in California.

k. FTB Chief Counsel Ruling 2011-01

(1) 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.

4. 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 (SB 1015).

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 December 31, 2015, the California Supreme Court reversed, holding that California is not bound by the Compact and thus is not required to offer the three-factor election. Because the Compact is not a binding reciprocal agreement, California had the authority to unilaterally eliminate the election. The Legislature intended to supersede the election in 1993 when it generally required a double-weighted sales factor apportionment formula.

h. FTB issued Notice 2016-01 advising taxpayers that it will not take action on refund claims or protests involving the Compact election issue until the *Gillette* litigation is fully resolved.

i. On May 27, 2016, Taxpayer filed a petition for a writ of certiorari, which the U.S. Supreme Court denied on October 11, 2016.

5. 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 VI.C.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.

6. 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.

7. In 2009, the statutory definition of "gross receipts" under RTC § 25120 was amended to exclude 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.

8. FTB Technical Advice Memorandum 2015-01

a. Payments received pursuant to cost sharing arrangements constitute gross receipts for sales factor purposes, where transaction produces business income in which income, gain or loss is recognized under the Internal Revenue Code.

b. While the definition of gross receipts under RTC § 25120(f)(2) is not tied to the Internal Revenue Code for years prior to 2011, FTB will follow federal law for prior years as well.

9. 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.

10. *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.

11. FTB Chief Counsel Ruling 2012-01

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

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

B. Distortion 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 distortion.

(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. Banks and Financial Corporations

a. On December 4, 2014, the FTB held an interested parties meeting to discuss a possible regulatory effort to address certain apportionment issues involving combined reporting groups that include both banks/financial corporations and general corporations.

b. The FTB indicated that the purpose of the meeting was to elicit public input regarding issues that may arise when the financial

activities of the group predominant and thus existing Regulation 25137-10 does not apply.

c. The meeting discussion focused on prospective changes to address the issue of a combined reporting group comprised of both bank/financial entities and general corporations, such as a registered broker-dealer, and the inclusion in the sales factor of the gross receipts from the activities of the broker-dealer.

d. A second interested parties meeting was held on April 20, 2016. On June 9, 2017, the FTB posted on its website a supplemental request for comments regarding possible approaches to addressing the broker-dealer issue.

e. *UBS AG and Combined Affiliates*, SBE Case. No. 997309; OTA Case No. 18011773.

(1) A case which involved an issue whether the FTB improperly invoked RTC § 25137 to include in the appellant's sales factor denominator the proceeds from appellant's securities broker-dealer's principal trading transactions at net instead of gross. The case has been settled.

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

(1) In a summary decision, the SBE 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).

(2) The SBE also determined that the gain from goodwill on the sale of a corporation's assets is business income.

c. 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.

d. In Chief Counsel Ruling 2015-01, the FTB concluded that a sale of a line of business was both substantial and occasional under Regulation 25137(c)(1)(A). Although the taxpayer from time to time acquired or disposed of brands to expand or redirect its business, such activity was not a regular or systematic occurrence in the taxpayer's corporate life. Also, this was the only time that the taxpayer disposed of an entire line of business, including all the brands within that line.

e. In Chief Counsel Ruling 2017-03, the FTB concluded that a taxpayer's divestiture of its U.S. businesses was both substantial and occasional under Regulation 25137(c)(1)(A) where its unitary parent company had four prior divestitures in an eight year period, and taxpayer had one previous divestiture.

7. Space Transportation Activities

a. On July 9, 2015, FTB held an interested parties meeting to discuss a possible regulatory effort to add a new Regulation 25137-15 to address the apportionment and allocation of income derived from space transportation activities. A second interested parties meeting was held on April 13, 2016 to discuss draft language for a proposed regulation.

b. On July 12, 2016, FTB approved the staff request to proceed with the formal regulatory process. On September 28, 2017, Regulation 25137-15 was adopted, effective for taxable years beginning on or after January 1, 2016.

8. Alternative Apportionment Method Petitions

a. On June 15, 2017, the 3-member FTB denied a petition by Philip Morris to use an alternative apportionment method under RTC § 25137 consisting of a payroll, sales and double-weighted property factor instead of the standard single-sales factor apportionment formula for its 2013 tax year.

b. On June 30, 2017, the FTB held an interested parties meeting to discuss rules and procedures pertaining to the consideration of alternative apportionment method petitions under RTC § 25137 by the three-member FTB.

c. In FTB Notice 2017-05, the FTB announced that taxpayers would now be permitted to make oral presentation to FTB staff on RTC § 25137 petitions.

d. In FTB Resolution 2017-01, the FTB explained its new policy prohibiting ex parte communications between taxpayers and FTB board members and staff during the pendency of taxpayers' RTC § 25137 petitions before the 3-member FTB.

e. In FTB Notice 2018-02, the FTB informed taxpayers and their representatives that they may request permission to make oral presentations to FTB staff in connection with FTB staff-initiated proposed alternative apportionment under RTC § 25137. The notice also outlined the procedures to request such oral presentation.

f. In FTB Guidelines to Implement Resolution 2017-01, the FTB explained that Resolution 2017-01 applies once a taxpayer files a confidentiality waiver and appeals an adverse RTC § 25137 Committee determination.

C. Application of Federal Provisions to Apportioning Taxpayers

1. In Technical Advice Memo 2017-02, the FTB concluded that income should be apportioned according to the factors in the year of the sale, when an apportioning S corporation sells or otherwise disposes of property generating net recognized built-in gain.

2. In Technical Advice Memo 2017-03, the FTB provided guidance on the application of IRC §§ 382 to 384 for California tax purposes as it relates to apportioning taxpayers, including that the limitation under IRC § 382(b)(1) is applied on a pre-apportionment basis.

II. **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 (Comcast) was engaged in a single unitary business with a majority-owned corporation (QVC). *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.

4. On February 9, 2015, the trial court ruled that taxpayer was the "prevailing party" with respect to the unitary issue and thus was entitled to recover litigation costs.

5. On December 14, 2016, the Court of Appeal in an unpublished opinion affirmed the trial court's ruling that the break-up fee was business income and that Comcast and QVC were not engaged in a single unitary business. The Court also rejected the taxpayer's claims that its tax liability should be recalculated by including the break-up fee in its sales factor denominator, because the taxpayer failed to include the issue in its refund claim or original complaint.

6. Neither party petitioned the Supreme Court for review. On January 3, 2017, FTB requested a partial publication of the opinion on the break-up fee issue. The Court of Appeal wrote a letter to the Supreme Court recommending the opinion remain unpublished. The Supreme Court denied the FTB's request.

B. *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 challenged the constitutionality of the LCUP.

3. On December 31, 2015, the trial court sustained the FTB's treatment of the gain as apportionable business income and the FTB's imposition of the LCUP.

4. Taxpayer filed an appeal on March 2, 2016. On July 27, 2017, the Court of Appeal reversed the trial court's judgment and remanded the case to trial court. While the trial court's business income conclusion may be supported by substantial evidence, the Court remanded the case because the trial court did not make a finding on whether the stock which was sold was integral to the operations of the taxpayer at the time of the stock sale.

C. *Bank of America Corp.*, SBE Case No. 983272 (2017)

1. On November 14, 2017, the SBE ruled that dividends received by Bank of America from one of its Chinese affiliates was nonbusiness income because there was a lack of integration or interwoven ties between the affiliates. FTB has filed a petition for rehearing.

D. *Leslie's Holdings, Inc.*, SBE Case No. 955278 (2017)

1. On November 15, 2017, the SBE ruled that 84 percent of interest expense incurred as a result of borrowing to conduct a corporate reorganization was a nonbusiness expense allocated to taxpayer's commercial domicile in Arizona. The remaining 16 percent of the interest expense was found to be an apportionable business expense because it was attributable to borrowing to make distributions to employees.

2. Compare *Levi Strauss*, below.

E. *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.

   Prior to the SBE hearing, the case settled.

F. *ConAgra Foods, Inc.*, SBE Case Nos. 597512, 785058, 799162 (2015)

1. On August 25, 2015, the SBE ruled in a summary decision that gain from the sale of Pilgrim's Pride stock that the taxpayer received from the sale of its chicken processing business was nonbusiness income. Such stock represented a minority interest (7 percent) in Pilgrim's Pride, a large publicly owned company. The taxpayer and Pilgrim's Pride were managed and operated independently, with no sharing of officers or directors. Although the taxpayer entered into a supply agreement with Pilgrim's Pride, the agreement merely provided that taxpayer would offer Pilgrim's Pride the first opportunity to provide chicken at fair market value and in volumes similar to past volumes.

2. In a separate transaction, the taxpayer sold its fresh beef and pork operations to Swift Foods, a new joint venture, and received cash, notes and a 46 percent equity interest in the joint venture. The joint venture was formed to hold the taxpayer's fresh beef and pork operations, which constituted substantially all of the operating assets of the joint venture. The taxpayer provided debt financing for the new venture and continued to use fresh beef and pork from the operations as an integral part of its packaged food business. The SBE ruled that the income earned from taxpayer's equity and debt interests in the joint venture was business income.

G. 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.

III. **Nexus**

A. "Economic" Nexus Standard

1. The definition of "doing business" under RTC § 23101 was amended for tax years beginning on or after January 1, 2011.

2. 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:

a. The taxpayer is organized or commercially domiciled in this state;

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

c. 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;

d. 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.

3. However, in the Assembly Floor analysis for the bill (AB X3 15), it is stated that because of federal law (e.g., P.L. 86-272), 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."

4. The inflation-adjusted threshold values for 2018 are $583,867 in California sales and $58,387 in California property or payroll.

B. FTB Chief Counsel Ruling 2016-03

1. The FTB ruled that the proceeds from sales of tangible personal property (TPP) should be aggregated with royalties received, for purposes of

determining whether the sales threshold under California's "doing business" standard has been met.

2. In CCR 2016-03, the taxpayer was not required to throw back to its California sales factor numerator the sales of TPP from States where it met the sales threshold under California's "doing business" standard and its activities exceeded the protections under P.L. 86-272.

C. FTB Chief Counsel Ruling 2012-03

1. The FTB ruled that foreign sales of 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.

   a. 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.

   b. 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.

2. 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.

D. FTB Technical Advice Memorandum 2012-01

1. 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.

2. 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.

E. FTB Chief Counsel Ruling 2012-07

1. 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.

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

1. 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.

G. *Harley-Davidson, Inc. v. FTB*, 237 Cal. App. 4th 193 (2015)

1. Case involves issue whether certain bankruptcy-remote special purpose entities (SPEs) formed to securitize loans originated by affiliated corporations are not taxable in California due to the lack of nexus with the State.

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

3. On May 28, 2015, the Court of Appeal affirmed on the nexus issue. Although the SPEs had no physical presence in California, the Court held that the SPEs had California nexus due to the in-state activities conducted by their affiliate, as agent of the SPEs.

4. On September 16, 2015, the California Supreme Court denied the taxpayer's petition for review.

5. Case also involves a combined reporting issue which has recently been decided by the Court of Appeal. See Section IX.B.1 below.

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

1. 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.

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

I. *Swart Enterprises v. FTB*, California Court of Appeal, Fifth Appellate Dist. Case No. F070922

1. 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.

2. Involves 2009 tax year, prior to the 2011 amendment to RTC § 23101 and the enactment of the new economic nexus standard.

3. See FTB Legal Ruling 2014-01 below.

4. On November 14, 2014, the trial court affirmed its tentative ruling granting taxpayer's motion for summary judgment and denying FTB's motion for summary judgment.

5. On January 16, 2015, FTB filed an appeal. On January 12, 2017, the Court of Appeal issued its opinion affirming the trial court's ruling.

6. On February 28, 2017, the FTB issued Notice 2017-01 indicating that the FTB "will follow the Court of Appeal decision in *Swart* in situations with the same facts."

7. In an FTB Tax News Article from March 2018, FTB stated that "taxpayers [claiming refunds based on *Swart*] must substantiate their factual situation is the same as the facts in *Swart* for each taxable year at issue." FTB noting that "factual situation[s] can potentially vary from year to year (e.g., the taxpayer's membership interest percentage in the LLC could change; or the LLC could switch from being manager-managed to member-managed, or vice-versa)."

8. The trial court awarded *Swart* $1,107,029.38 for recovery of attorney fees. See Section IX.A, below.

J. In FTB Legal Ruling 2014-01, while *Swart* was pending (see above), 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.

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

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

3. In light of the Court of Appeal's decision in *Swart* and FTB Notice 2017-01, the FTB may need to revise or withdraw Legal Ruling 2014-01.

K. *The Rasmussen Company, Inc. v. FTB*, San Francisco Superior Court Case No. CGC-16-554150

1. Class action lawsuit to recover the $800 annual franchise tax collected by the FTB from out-of-state companies.

2. Issue is whether an out-of-state company is "doing business" in California solely through its passive membership interest in an LLC registered to do business in California.

3. By the trial court's order entered on June 2, 2017, the case is stayed pending determination of the appeal in *Bakersfield Mall* (see IX.E.3 below).

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

1. 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.

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

3. See FTB Legal Ruling 2011-01 below.

4. 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.

5. 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. On February 22, 2017, the parties filed additional briefs upon the Court's request. On June 22, 2017, taxpayer submitted a letter in response to the Court's request for an opinion on the independent viability of taxpayer's Settlement Bureau causes of action if the FTB prevailed on the issue whether FTB's assessment of taxpayer was correct.

6. On September 21, 2018, the case was finally argued in the Court of Appeal. One week later, the Court of Appeal issued a published opinion affirming the trial court in favor of the FTB.

   a. The Court concluded that neither RTC § 18633 nor RTC § 23038 replaced the use of the UDITPA apportionment formula for unitary businesses.

   b. The Court held that the owners of the single member LLC had nexus.

   c. The Court distinguished *Swart*.

d. The Court rejected the taxpayer's double taxation arguments.

e. The Court did not reach the issue of whether the settlement process was unfair.

M. In FTB Legal Ruling 2011-01, while *Bunzl* was pending (see above), the FTB ruled that mere ownership of a disregarded entity doing business in California creates California franchise tax nexus for the owner.

N. *Appeal of Craigslist, Inc.*, SBE Case No. 725838 (Dec. 16, 2015)

1. Under a special apportionment formula approved by the FTB, the taxpayer was allowed to use a modified market-based sourcing method for tax years 2007 to 2010, where sales to states where taxpayer was not subject to tax under U.S. constitutional standards were required to be excluded from the sales factor.

2. Taxpayer argued that sales to other states should not be excluded from the sales factor where taxpayer would be subject to tax in such other states under the "economic nexus" standard that California adopted in 2011. Presumably, California's position is that economic nexus satisfies U.S. constitutional standards.

3. SBE ruled that the taxpayer was required to exclude such sales because California's economic nexus standard was not in effect prior to 2011.

O. FTB Notice 2016-02—See Section IV.D below regarding the effect of economic nexus on an existing water's edge election.

IV. Water's Edge Election

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

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

2. 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 V.A below)

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.

D. FTB Notice 2016-02

1. In Notice 2016-02, the FTB addressed the effect on an otherwise-valid water's edge election when a unitary foreign affiliate of a water's edge combined reporting group becomes a taxpayer because it is "doing business" in California due to the addition of California's "economic nexus" standard beginning in 2011.

2. The FTB announced that, in certain situations, a unitary foreign affiliate that becomes a taxpayer due to economic nexus will be deemed to have made a water's edge election.

3. In Notice 2017-04, the FTB extended its policy set forth in Notice 2016-2 for treatment of water's-edge elections when foreign affiliates become taxpayers due solely to economic nexus to include in the water's edge group those foreign affiliates that become California taxpayers in tax years starting on or before December 31, 2017.

E. FTB Chief Counsel Ruling 2017-2

1. Taxpayer who previously filed on a worldwide basis acquired a corporation filing on a water's-edge basis deemed to have made a water's edge election because the goodwill from the acquisition caused Target's assets to exceed those of the Taxpayer.

2. Goodwill recorded as a result of the Taxpayer's acquisition of the Target should be reflected in the total business assets of the Target.

V. Expense Attribution & Foreign Investment Interest Offset

A. *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 IV.B above.

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

VI. 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. 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.

6. In its Tax News dated December 2013, the FTB stated that "[i]f the IRS audited the Research Credit, we will generally follow the federal determination."

   a. However, while the FTB is now somewhat more reasonable with respect to R&D credit claims that have been audited by the IRS, the FTB will nevertheless conduct its own audit in some circumstances.

7. In Technical Advice Memorandum 2018-01, the FTB explained, for credits attributable to disregarded entities, the RTC § 23036(i) limitation attaches to a credit at the time the credit is generated and becomes a permanent limitation.

B. Governor's Economic Development Initiative

1. California Competes Credit—Tax credits to retain or attract new business activity in California, to be administered by the Governor's Office of Business and Economic Development (GO-Biz).

   a. Credits are available for allocation during various application periods.

   b. Tax credit agreements are negotiated by GO-Biz subject to approval by a statutorily created California Competes Tax Credit Committee.

   c. Credit agreements must contain a credit recapture provision, which may be triggered if the taxpayer fails to achieve the agreed upon California employment and investment levels.

   d. FTB is responsible for reviewing taxpayer books and records to verify compliance with those agreements and recommending any credit recapture to the Committee.

e. FTB issued Notice 2014-02 setting forth general procedures applicable to FTB's review of taxpayer compliance with credit agreements.

(1) On February 19, 2015, FTB held an interested parties meeting regarding FTB's credit agreement review procedures.

(2) FTB indicated that information requested in the course of credit agreement reviews would focus on compliance with the credit agreement. However, FTB would not be prohibited from using such information in an income or franchise tax audit unrelated to the credit agreement review.

f. Trial court invalidated GO-Biz regulation provision limiting contingency fee arrangements to secure California Competes Credits. *Ryan U.S. Tax Servs. LLC v. California*, Sacramento Superior Court, Case No. 34-2014-00167988 (Jan. 7, 2016). On March 1, 2016, the State filed an appeal to the Third Appellate District, Case No. C081524. Case voluntarily dismissed on November 7, 2016.

(1) On August 5, 2016, GO-Biz proposed removing the provision limiting contingency fee arrangements from its regulation in light of a statutory amendment enacted June 27, 2016, allowing GO-Biz to consider the reasonableness of fee arrangements with third party services providers.

g. AB 2900 was approved on September 24, 2016 to add new online information disclosure requirements regarding taxpayers awarded California Competes Credits.

h. On August 10, 2018, GO-Biz proposed regulatory amendments to include a new process for a taxpayer to request permission to submit an application before the next designated application period. The proposed regulatory amendments also specifies and clarifies definitions and deletes obsolete provisions.

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

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

C. Separate But Unitary

1. *General Motors Corporation v. FTB*, 39 Cal. 4th 773 (2006)

a. California Supreme Court rejected the taxpayer's argument that a research expense credit should be applied against the tax liability of the unitary group, or in the alternative, should be "intrastate-apportioned" against the tax liability of each of the taxpayer-members of the unitary group.

b. The Court accepted the FTB's argument that the credit should be limited to the taxpayer which incurred the research expenses.

2. Cases are pending in the administrative process challenging the siloing of credits, which may result in distortion under RTC § 25137 when combined with the assignment of business income to each member of the unitary group under intrastate apportionment.

a. In Chief Counsel Ruling 2012-01, FTB's position is that intrastate apportionment is not a proper subject for relief under § 25137. See Section I.A.6 above. Query whether FTB's position applies to all factual situations, including those that lead to unconstitutional or impermissible levels of distortion.

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.

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 first interested parties meeting to discuss draft language for proposed regulations to address defective credit assignments under RTC § 23663. FTB staff made proposed amendments to the draft regulatory language based on comments at the June 12, 2014 interested parties meeting. Staff issued a 60-Day Notice of Changes to Proposed Regulation.

f. On November 24, 2017, the FTB issued revised draft proposed regulations to address defective credit assignments under RTC § 23663, which is pending review.

g. On June 12, 2018, the FTB held a second interested parties meeting to discuss draft language for proposed regulations to clarify rules for the eligibility of credit assignees that are impacted by corporate mergers, acquisitions and reorganizations.

VII. **Tax Shelters**

A. On March 24, 2011, California enacted legislation applicable to the use of abusive tax avoidance transactions (ATATs) (Senate Bill No. 86.)

1. 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 ("NEST") penalty. RTC § 19777(b).

2. Statute of limitations for assessments relating to ATATs was extended to 12 years from the due date or filing of the return. RTC § 19755(a)(2).

3. Under RTC § 19774, the definition of a NEST was expanded.

a. A NEST includes the "disallowance of any loss, deduction or credit, or addition to income attributable to a determination that the disallowance or addition is attributable to a transaction or arrangement that lacks economic substance including a transaction or arrangement in which an entity is disregarded as lacking economic substance."

b. A transaction is treated as lacking economic substance if the taxpayer does not have a valid nontax California business purpose for entering into the transaction.

c. A NEST also includes a transaction that lacks economic substance within the meaning of Internal Revenue Code § 7701(o), with certain language modifications.

B. *Appeal of Joseph Francis*, SBE Case No. 523692 (May 22, 2013)

1. In a summary decision, the SBE ruled that the FTB properly disallowed certain losses generated by a "Son of BOSS" transaction, which the SBE concluded lacked economic substance. The SBE determined that (1) the taxpayer failed to show subjective intent of entering into the transactions for financial profit and (2) by any objective measure, the transactions at issue were not capable of producing an overall economic benefit aside from the tax losses.

2. The SBE also ruled that the FTB properly disregarded a Nevada corporation as a separate entity, where the taxpayer failed to show that the corporation was formed for a business purpose and that the transactions with the corporation had economic substance.

3. The SBE concluded that imposition of the NEST penalty was proper.

C. *Appeal of Khoury*, SBE Case No. 867810 (May 26, 2016)

1. In a summary decision, the SBE ruled that the taxpayer's sale of a limited partnership interest on an installment sale basis should not be disallowed under the economic substance doctrine or other judicial standards.

2. The SBE concluded that the NEST penalty could not be imposed as the taxpayer owed no additional tax.

D. *Appeal of The Sherwin Williams Co.*, SBE Case No. 785285

1. At a hearing on February 22, 2017, the SBE agreed with the taxpayer that the company's transactions involving an Employee Stock Ownership Plan (ESOP) had a legitimate business purpose and were not a tax shelter.

2. The SBE requested additional information regarding valuation issues and the impact of a closing agreement between the IRS and the taxpayer. The appeal was closed by the parties.

E. 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.

F. 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.

G. *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.

H. *Myles Hubers v. FTB,* San Diego County Superior Court Case No. 37-2016-00045238

1. Pending case in trial court regarding issue whether the creation of an ESOP and a management agreement were properly disregarded by FTB as abusive tax avoidance transactions. The parties settled in May 2018, and the action was dismissed.

VIII. **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. For tax years beginning in 2010, the LCUP threshold was amended to understatements that exceed both $1 million and 20 percent of the tax shown on the original return. RTC § 19138(a)(1).

2. In the case of taxpayers filing a combined report, the LCUP understatement 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.

d. On September 30, 2015, Governor Brown signed AB 154, the omnibus federal conformity bill, which also included provisions to expand the exceptions to the LCUP. The LCUP will not apply in the following situations: (1) FTB imposition of an alternative apportionment or allocation method under RTC § 25137, (2) certain IRS changes to the taxpayer's federal accounting method and (3) filing an amended return to reflect a proper election under IRC § 338. The above provisions generally are effective for taxable years beginning on or after January 1, 2015, except that the LCUP exception relating to the FTB's imposition of an alternative apportionment method would apply to taxable years for which the statute of limitation on assessments has not expired as of September 30, 2015.

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 Court of Appeal affirmed the trial court's decision. *California Taxpayers' Association v. FTB*, 190 Cal. App. 4th 1139 (2010). In response to Cal-Tax's procedural Due Process argument, the Court noted that taxpayers can file a refund suit to challenge the LCUP and would not be limited to computational grounds. Cal-Tax's petition for review was denied on March 16, 2011.

8. 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*, 186 Cal. App. 4th 922 (2010). 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.

C. NEST Penalty—See Section VII.A.3 above.

IX. **Miscellaneous**

A. Attorney's Fees

1. *Swart Enterprises v. FTB*, California Court of Appeal, Fifth Appellate Dist. Case No. F070922. (See Section III. I above.)

   a. On June 23, 2017, *Swart* filed a motion with the trial court seeking to recover $1,917,710.31 of reasonable attorney fees. *Swart Enterprises v. FTB*, Fresno Superior Court Case No. 13CECG02171

   b. On October 11, 2017, the trial court awarded *Swart* $1,107,029.38 in reasonable attorney fees.

   c. On December 12, 2017, FTB filed an appeal of the trial court's attorney fee award.

   d. On December 15, 2017, *Swart* filed a cross-appeal of the trial court's attorney fee award.

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. On November 25, 2014, the Nevada Supreme Court denied petitions for rehearing filed by both parties.

f. On June 30, 2015, the U.S. Supreme Court granted FTB's petition for a writ of certiorari. On April 19, 2016, issued its decision holding that if the FTB is haled into a Nevada court, the FTB as a government agency of a sister state is entitled to the same Nevada statutory cap on damages applicable to Nevada government agencies.

g. On June 28, 2018, the U.S. Supreme Court once again granted FTB's petition for a writ of certiorari to decide whether to overrule its 1979 decision in *Nevada v. Hall*, 440 U.S. 410 (1979), which allowed plaintiffs to bring lawsuits against states in the courts of a sister state.

h. 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) On February 10, 2015, the district court dismissed Hyatt's suit for lack of jurisdiction under the federal Tax Injunction Act.

(2) On February 19, 2015, Hyatt filed an appeal with the Ninth Circuit Court of Appeals. Briefing has been completed. Oral argument was heard on February 17, 2017.

(3) On September 26, 2017, the Ninth Circuit affirmed the district court's dismissal of Hyatt's suit, because plaintiff "still had a plain, speedy, and efficient remedy" available.

i. On August 29, 2017, the SBE issued its ruling in the underlying case regarding residency and source of income issues. The SBE ruled Hyatt was not a California resident in late 1991 and early 1992, when he received large sums from his patent. The SBE also ruled that Hyatt's earnings in 1991, but not in 1992, were California-source income based on where the activity to produce such income occurred. As a result, most of the $55 million in taxes, penalties and interest assessed by the FTB was overturned.

(1) The FTB petitioned the SBE for a rehearing, but the SBE did not rule on this before its appellate functions were transferred to the Office of Tax Appeals (OTA).

(2) In early 2018, the OTA asked both Hyatt and the FTB to submit briefs on the rehearing request.

B. Combined Reporting

1. *Harley-Davidson, Inc. v. FTB*, 237 Cal. App. 4th 193 (2015)

a. Case involves issue whether FTB improperly discriminates against multistate unitary corporate taxpayers be requiring combined reporting and not allowing them to choose separate reporting. The trial court sustained FTB's demurrer regarding this issue.

b. Case also involves nexus issues. See Section III.G above.

c. On May 28, 2015, the Court of Appeal reversed the trial court's order sustaining the FTB's demurrer and remanded for further proceedings on taxpayer's discrimination claim.

d. On October 31, 2016, the trial court granted the FTB's motion for summary judgment. On December 27, 2016, taxpayer filed a notice of appeal.

e. On August 22, 2018, the Court of Appeal affirmed the judgment of the trial court. Since there is a legitimate state interest to accurately measure and tax all income, the Court held that California can require interstate unitary businesses to use combined reporting. *Harley-Davidson, Inc. v. Franchise Tax Board*, No. D071669 (Cal. Ct. App., Aug. 22, 2018).

2. *Abercrombie & Fitch v. FTB*, Fresno Superior Court No. 12CECG03408.

a. Case involving similar combined reporting issue as in *Harley-Davidson* above.

b. Trial court found in favor of FTB and taxpayer filed a notice of appeal on December 7, 2016. The case is fully briefed.

3. *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. The parties settled, and on September 9, 2016, the action was dismissed.

4. FTB Legal Ruling 2015-02

   a. Exercising its authority under RTC § 25102, FTB may reallocate income and expenses from transactions involving interest charged domestic international sales corporations (IC DISCs) owned by persons not included in a combined report.

5. Excess Inclusion

   a. FTB Legal Ruling 2009-01 addressed how excess inclusion is determined for a Non-Economic Residual Interest Holder (NERIs) in a Real Estate Mortgage Investment Conduit (REMIC) in a combined report.

   b. FTB Information Letter 2009-01 addressed the application of the excess inclusion rules to non-NERI members of a combined report.

   c. FTB Technical Advice Memorandum 2018-02 concluded that excess inclusion pertaining to all the NERIs in a combined report is aggregated and thereafter apportioned to each NERI using the NERI's California apportionment factor percentage.

C. 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 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 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 (and Regulation 17951-4 as applicable to nonresident individuals). 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.

c. On November 3, 2017, the FTB staff issued proposed amendments to Regulation 25137-1 and Regulation 17951-4.

d. On December 18, 2017, the FTB staff held a public hearing on the proposed amendments to Regulation 25137-1 and Regulation 17951-4. In response to public comments at the hearing, the FTB staff revised proposed amendments to Regulation 17951-4 by removing any reference to RTC § 17952.

e. The FTB considered the revisions to the proposed regulations on April 12, 2018 at a Board Meeting and voted unanimously to proceed with the formal regulatory process under the Administrative Procedures Act (APA).

D. Partnerships

1. *Appeal of Michael and Mary Bills*, SBE Case Nos. 610028 and 782397

a. Case involved a partner in a California investment firm who retired and moved to Washington in January 2005.

b. The FTB took the position that the taxpayers were still California residents until April 2005 and that the withdrawal payments which Mr. Bills received were California source income.

(1) Taxpayers argued that the payments were for the liquidation of a partnership interest under IRC § 736(b)—an intangible—the income of which should be sourced to Washington, the taxpayers' state of residency.

(2) Taxpayers also argued that they changed their residency to Washington in January 2005, not April 2005.

c. On June 3, 2015, the SBE ruled in favor of the taxpayers on both issues and abated 5 years of proposed assessments. The FTB filed a petition for rehearing on the sourcing issue. On March 29, 2016, the SBE denied the FTB's petition for rehearing. A summary decision was issued.

E. 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 trial court denied class status for LLCs that derive all income from within California.

c. Discovery 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 the trial court. The issue regarding the denial of class certification was appealed.

e. On July 18, 2018, the Court of Appeal reversed the trial court's denial of class certification for LLCs seeking refunds for an unconstitutional levy. The Court also concluded that all LLC claimants have filed their own individual refund claims, thereby exhausting their own administrative remedies.

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.

d. On July 18, 2018, the Court of Appeal reversed the trial court's denial of class certification. See *Bakersfield Mall* above.

5. FTB Legal Ruling 2016-01

a. FTB addressed the issue whether, for purposes of calculating California's LLC fee, cost of goods sold includes the adjusted basis of real property held for sale to customers in the ordinary course of business.

b. The LLC fee is based on gross income, plus the cost of goods sold. The FTB ruled that if the LLC sold property held for sale to customers in the ordinary course of its trade or business, the LLC's adjusted basis in the property should be added back to the LLC's gross income for purposes of calculating the LLC fee. If such property was held for investment purposes, the adjusted basis is not added back to the LLC's gross income for purposes of the LLC fee calculation.

6. FTB Chief Counsel Ruling 2015-02

   a. Single-member LLC that is "doing business" in California is subject to the LLC tax and fee, even though it is a disregarded entity and its sole member is a tax-exempt pension trust.

F. Nonwage Withholding

2. 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.

3. On December 12, 2014 and September 8, 2017, the FTB held interested parties meetings to discuss issues arising with pass-through entity withholding and issued draft proposed language for new Regulation 18662-7. On October 12, 2015, FTB held an interested parties meeting to discuss possible amendments to FTB's withholding regulations, followed by a second meeting on July 11, 2016 to discuss proposed amendments.

4. In Technical Advice Memorandum 2016-02, the FTB outlined the statute of limitations period for refunds of amounts collected from withholding agents for failure to withhold.

G. IRC § 1031 Exchange

1. *Appeals of Rago et al.*, 2015-SBE-01 (June 23, 2015)

   a. In a formal opinion, the SBE reversed the FTB and ruled that taxpayers' transaction qualified as a like-kind exchange under IRC § 1031 and that the step transaction doctrine should not be applied.

   b. Relying on federal authorities, the SBE rejected the FTB's more restrictive interpretation of the requirements under IRC § 1031.

2. *David & Alicia Smith v. FTB*, San Diego Superior Court No. 37-2015-00014020

   a. Suit filed on April 27, 2015 on refund claim based on FTB's disallowance of deferred gain on a sale or exchange of real property under IRC § 1031. Trial commenced on April 3, 2017.

   b. Trial commenced on April 3, 2017. On June 23, 2017, judgment was entered in favor of FTB.

3. Draft Regulations 17951-7 and 25137(e)

   a. On February 3, 2016, FTB held an interested parties meeting to discuss potential regulations that would address the sourcing of gains/losses for IRC § 1031 exchanges and which year's apportionment factors that should be applied to such gains/losses.

4. In its Tax News dated September 2018, the FTB stated that "[s]ince California law conforms to the federal rules for like-kind exchanges under IRC Section 1031, as of the 'specified date' of January 1, 2015, with modifications, it does not conform to the federal law that now limits like-kind exchanges to real property that is not held primarily for sale."

H. Federal Check-the-Box Rules

1. On May 11, 2018, the FTB published a Notice of Proposed Rulemaking to make California consistent with the corresponding federal check-the-box regulations, to the extent those regulations are applicable to California's income and franchise tax law.

X. Legislative Updates and Ballot Measures of Note

A. 2017-2018 Legislative Session

1. SB 567 was introduced to eliminate the water's edge election and limit corporation tax deductions for executives' pay. The provision to eliminate the water's edge election was removed from SB 567. On February 1, 2018, SB 567 died on file pursuant to Joint Rule 56.

2. SB 66 was introduced which would eliminate the tax deduction for punitive damages.

3. SB 539 was enrolled and presented to the Governor on September 12, 2018. This bill, in response to the $10,000 federal SALT deduction limit, modifies an existing College Access Tax Credit program to allow taxpayers a 75% tax credit for amount contributed. On September 28, 2010, Governor Brown vetoed SB 539.

4. On September 23, 2018, Governor Brown signed SB 274, which authorizes the FTB to collect from partnerships or their partners state tax liability resulting from federal partnership audits.

5. On June 27, 2017, Governor Brown signed a $183.2 billion budget for 2017-18 (AB 97), including a budget trailer bill (AB 102), which provides for a complete restructuring of the state's tax administration structure. See Section X.D below.

6. California does not automatically conform to all of the changes to the Internal Revenue Code made by the Tax Cuts and Jobs Act of 2017 (Jobs Act of 2017). California selectively conforms to changes to the Internal Revenue Code.

    a. Jobs Act of 2017 provisions related to Global Intangible Low Tax Income (GILTI), Foreign Derived Intangible Income (FDII), repatriation, and dividends received deductions, among others, do not automatically apply in California. See FTB Preliminary Report on Specific Provisions of the Tax Cuts and Jobs Act, March 20, 2018.

    b. The FTB issued guidance to address how taxpayers should adjust their 2017 California returns for IRC section 965 amounts reported on their 2017 federal returns. See FTB California Guidance – Taxable Year 2017 IRC Section 965 Reporting, Rev. May, 22, 2018.

    c. The Protect California Taxpayers Act (SB 227) was introduced January 8, 2018. The Act would allow taxpayers to make charitable donations to the California Excellence Fund, and in return receive a dollar-for-dollar income tax credit on the full amount of their contribution. This proposal is intended to avoid the $10,000 cap on deductions for state and local taxes added to the Internal Revenue Code by the Jobs Act of 2017. The California Legislature abandoned SB 227 in mid-August 2018 (currently suspended) and instead amended SB 539.

    d. Proposed legislation (Senate Bill 1398) would increase the corporate income/franchise tax rate of publicly-held corporations from the current 8.84 percent (10.84 percent for financial corporations) to as high as 13 percent (15 percent for financial corporations), depending on the ratio of total compensation of the corporation's highest-paid employee to the median rate of compensation for all employees.

(1) If the compensation ratio falls between 0 and 50, the company would be taxed at current tax rates; if between 50 and 100, at a 10-percent tax rate (12 percent for financial corporations); if between 100 and 200, at an 11-percent tax rate (13 percent for financial corporations); if between 200 and 300, at a 12-percent tax rate (14 percent for financial corporations); and if over 300, at a 13-percent tax rate (15 percent for financial corporations).

(2) Senate Bill 1398 would increase the applicable corporate tax rate of publicly-held corporations by an additional 50 percent for taxpayers who decrease full-time U.S.-based employees by more than 10 percent and increase the number of full-time foreign-based employees during the tax year.

e. The Middle Class Fiscal Relief Act Proposed Assembly Constitutional Amendment 22 (ACA 22), introduced January 18, 2018, would impose a surcharge of 10 percent on corporate net income over $1,000,000.

(1) Section 1 of ACA 22 states that "[t]he purpose of this article is to share with ordinary California taxpayers the economic gains provided by federal income tax cuts for corporations with over one million dollars ($1,000,000) in net income."

(2) The 10 percent surcharge would also apply to S-corporations with net incomes in excess of $1 million.

B. 2015-2016 Legislative Session

1. On September 30, 2015, Governor Brown signed AB 154, the omnibus federal conformity bill, which changes California's specified date of conformity to the Internal Revenue Code to January 1, 2015, for taxable years beginning on or after January 1, 2015. The previous conformity date was January 1, 2009.

2. AB 154 also included legislation expanding the exceptions to the LCUP. See Section VIII.A.5.d above.

3. AB 1775 was approved on September 14, 2016 to change the State's return filing due dates for partnerships, LLCs and C corporations to conform to recent federal due date changes. The change applies to taxable years beginning on and after January 1, 2016.

4. AB 2900 was approved on September 29, 2016 to increase online information disclosure requirements regarding taxpayers awarded California Competes Credits. See Section VI.B.1.g above.

C. 2016 Election Results

1. On November 8, 2016, Proposition 55 was approved by voters to extend by 12 years the temporary personal income tax increases enacted in 2012 on earnings over $250,000, with revenues allocated to fund education and healthcare.

D. State Board of Equalization and Tax Administration Reform

1. The Taxpayer Transparency and Fairness Act of 2017 (AB 102) was enacted on June 27, 2017

2. Eliminated the SBE's authority to administer most taxes and to adjudicate most tax appeals, including tax appeals for corporate income and franchise tax, personal income tax, and sales and use tax.

    a. The SBE will continue to administer and hear tax appeals only for property, insurance and alcoholic beverage taxes, as required under the California Constitution.

3. On July 1, 2017, the newly-created California Department of Tax and Fee Administration (CDTFA) began administering taxes other than property, insurance and alcoholic beverage taxes.

    a. Pursuant to clean-up legislation enacted September 16, 2017 (AB 131), appeals conferences must be conducted by the CDTFA in the same manner as before the July 1, 2017 transfer of duties from the SBE to the CDTFA.

    b. The CDTFA adopted emergency regulations on March 19, 2018, which largely incorporate former SBE regulations. The CDTFA proposed to readopt the emergency regulations on August 27, 2018.

4. As of January 1, 2018, tax appeals for taxes other than property, insurance and alcoholic beverage taxes are adjudicated by separate tax appeals panels established under the newly-created OTA.

    a. Each tax appeals panel consists of three administrative law judges (ALJs) designated by the director of the OTA. The director is appointed by the Governor.

b. Ex parte communications with tax appeals panel ALJs are prohibited.

(1) Beginning July 1, 2017, ex parte communications with SBE members in relation to any SBE adjudicatory proceeding, including proceedings involving property taxes, insurance taxes, and alcoholic beverage taxes heard by the SBE are prohibited.

c. Cases pending before the SBE as of January 1, 2018, will be heard by a tax appeals panel.

(1) AB 131 provides that the SBE will continue to hear open appeals only if the hearing, determination, decision, or any other action with respect to an appeal is placed on the calendar of a meeting of the SBE to be held before January 1, 2018, and the appeal is heard, determined, decided, or is otherwise final before January 1, 2018.

(2) On and after January 1, 2018, AB 131 confirms that the SBE has no legal authority to conduct appeals hearings, make determinations, issue or publish decisions, or take any other action with respect to an appeal heard at a meeting of the SBE before January 1, 2018, if the SBE's hearing, determination, decision, or any other action is, for any reason, not final before January 1, 2018.

d. The OTA began hearing tax appeals in January 2018.

5. The tax appeals panels are required to issue written opinions for each appeal within 100 days after rendering a final decision, and are generally required to conduct adjudicative hearings and proceedings under the APA.

a. Under the APA, an administrative decision must be in writing, be based on the record, include a statement of the factual and legal basis of the decision, and may not be relied on as precedent unless the agency designates and indexes the decision as precedential. The statement of the factual basis for the decision shall be based exclusively on the evidence of record in the proceeding and on matters officially noticed in the proceeding.

6. A person may be represented on an appeal before a tax appeals panel by any authorized person or persons, at least 18 years of age, of the person's choosing, including, but not limited to, an attorney, appraiser, accountant, bookkeeper, employee, business associate, or other person.

7. A decision of a tax appeals panel may be appealed by the party filing the appeal to the superior court in accordance with the law imposing the tax or fee. The taxing agency does not have the right to appeal to the superior court. The standard of judicial review to be applied by the superior court is de novo.

8. On December 26, 2017, the OTA adopted temporary emergency regulations setting forth the procedural rules for appeals before the OTA.

    a. These regulations are temporary, and OTA must issue final regulations by January 1, 2019.

9. The OTA issued a draft of proposed new regulations to set forth the procedural rules for appeals following the expiration of the current emergency regulations. The OTA held two informal interested parties meetings on April 16, 2018 and June 6, 2018. The public comment period closed on August 27, 2018.

    a. The OTA is expected to issue a Final Statement of Reasons in October 2018.

Sales and Use, Property and Other Taxes

XI. Sales and Use Tax

A. Sales and Use Tax Collection Nexus

1. The U.S. Supreme Court in *S. Dakota v. Wayfair, Inc.*, 138 S. Ct. 2080 (2018) overruled the "physical presence" requirement as "unsound and incorrect" and ruled that "substantial nexus" is satisfied when an out-of-state seller has sufficient "economic and virtual contacts" with the state.

2. In June 2018, the CDTFA accidently posted a draft guidance indicating California might impose a new collection requirement for retailers making cumulative sales in California exceeding $100,000 or individual sales of 200 or more.

3. In August 2018, the California Legislature proposed draft language to require remote sellers to collect use tax if they have total cumulative sales of tangible personal property exceeding $500,000. However, the draft language was never introduced into a bill before the end of the legislative session.

B. 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 Nos. BC402036 and BC448715); Court of Appeal Case No. B257808

    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.

    d. On October 8, 2015, the Court of Appeal held in favor of taxpayer that the software is a nontaxable TTA. The California Supreme Court denied review on January 20, 2016.

    e. In a March 18, 2016 memorandum, the SBE Legal Department recommended that the SBE amend Regulation 1507 to clarify the requirements to establish that an agreement for the transfer of software on tangible storage media is a software TTA in

accordance with *Lucent*. The Legal Department narrowly construed *Lucent*, indicating that *Lucent* is not dispositive with regard to embedded or preloaded software.

f. On March 30, 2016, SBE ordered that refunds be paid for cases that are clearly covered by the *Lucent* decision.

g. On June 17, 2016, SBE released its Initial Discussion Paper on proposed amendments to Regulation 1507 in light of *Lucent*.

h. On January 30, 2017, the Assembly Revenue and Taxation Committee held an informational meeting to discuss possible legislation in response to *Lucent*.

C. 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."

5. *City of Fontana v. Cal. Dep't of Tax and Fee Admin.*, Cal. Ct. of App. Case No. A147642 (Sept. 12, 2017)

a. Following an internal reorganization of a seller, the SBE decided that local sales tax that had been remitted to two cities should be reallocated to a third city.

b. The trial court set aside the SBE's decision, issuing a writ of administrative mandamus directing the Board to reconsider the issue. On appeal, the Court reversed and concluded that there was substantial evidence in the administrative record to support the SBE's decision. The Court filed a decision on rehearing on November 28, 2017.

6. Senate Constitutional Amendment (SCA) 20

a. SCA 20 was introduced on March 22, 2018 to change the distribution of local sales tax revenue from online sales to the purchaser's address or to any other delivery address designated by the purchaser, as opposed to the location of the in-state retailer.

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

1. *Littlejohn v. Costco Wholesale Corp*., 25 Cal. App. 5th 251 (2018)

a. The Court of Appeal affirmed the trial court decision that rejected the plaintiff's claims under the Unfair Practices Act and the Business and Profession Code for failing to notify retailers of a tax status change. In 2002, the SBE considered Ensure to be a nutritional supplement subject to sales tax. In 2006, due to a labeling change, Ensure's tax status changed to "a food product for

human consumption," the sales of which are not subject to sales tax.

2. *Loeffler v. Target Corp.*, 58 Cal. 4th 1081 (2014)

   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.

E. CDTFA Regulations and Notices

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.

   b. On September 25, 2014, the regulation became effective.

   c. On July 21, 2015, California Taxpayers Association filed a petition pursuant to Government Code § 11340.6, requesting the SBE amend Regulation 1525.4 to add language clarifying that taxpayers

may substantiate the useful life qualification of RTC § 6377.1 by reference to warranties, maintenance agreements or industry replacement standards. The SBE granted the petition.

d. On September 25, 2015, the SBE proposed to adopt amendments to clarify that taxpayers may substantiate the useful life of otherwise qualified tangible personal property using a warranty, service contract, or industry practice.

e. On February 24, 2016, the Office of Administrative Law ("OAL") disapproved the SBE's proposed amendments to Regulation 1525.4. OAL concluded that the SBE lacked the authority to make such amendments, which OAL found exceeded the scope of RTC § 6377.1.

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.

3. Special Notice: Amendments to the Manufacturing and R&D Partial Exemption

a. In December 2017, the CDTFA issued a Special Notice to highlight changes to the manufacturing and R&D partial exemption, including expanding the exemption to electrical energy production or storage equipment.

F. *Appeal of Solarcity Corporation*, SBE Case No. 668911

1. Taxpayer owned solar energy systems which it leased to customers. Under the California Solar Initiative program, rebates were provided to solar energy system owners to help reduce the owner's cost of installing the system. Although the taxpayer's lease agreements with its customers contained a rebate assignment provision, the lessees had no right to the rebates and thus had nothing to assign.

2. SBE staff took the position that the rebates received by the taxpayer are gross receipts subject to tax.

3. On August 31, 2016, SBE voted unanimously to grant the taxpayer's appeal and reject SBE staff's position.

G. *GMRI, Inc. v. California Dept. of Tax & Fee Administration*, 21 Cal.App.5th 111 (2018)

1. The Court of Appeal affirmed a lower court decision which concluded that a gratuity charge for large parties is part of a restaurant's gross receipts subject to state sales tax. The Court of Appeal found the gratuity charge to be a mandatory payment because the restaurant added the charge without first conferring with the customers.

H. Legislative Updates

1. On February 5, 2018, Senator Hertzberg introduced SB 993 to create a tax on services purchased by businesses. SB 993 did not advance following its most recent May 16, 2018 hearing. SB 993 is dead for the current 2017-2018 legislative session, but Senator Hertzberg intends to continue pursuing the bill.

XII. **Property Tax**

A. *Time Warner Cable Inc. v. County of Los Angeles*, 25 Cal. App. 5th 457 (2018)

1. On July 19, 2018, the Court of Appeal held that the county can value the company's possessory interests in public rights-of-way based on television, broadband, and telephone revenue.

B. *Beyl v. City of Yorba Linda*, No. G054057 (Cal. Ct. App., Apr. 27, 2018)

1. On April 27, 2018, the Court of Appeal found that it cannot adjudicate an assessment until the taxpayer comply with the mandatory claim process and allow the City of Yorba Linda an opportunity to correct its allegedly erroneous assessment.

C. *DeCaprio v. Alameda Cty. Bd. of Supervisors*, No. A151305 (Cal. Ct. App., Apr. 20, 2018)

1. On April 20, 2018, the Court of Appeal upheld the trial court's denial of taxpayer's writ of mandate compelling the county to set aside its denial of his cancellation claim because taxpayer failed to pay taxes prior to filing the claim.

D. *Machavia, Inc. v. County of Los Angeles*, 19 Cal. App. 5th 1050 (2017)

1. On December 29, 2017, the Court of Appeal found no merit in taxpayer's argument that the county either failed to notify taxpayer of tax bills or misled it regarding the need to pay. Therefore, the county was not equitably estopped from relying on taxpayer's failure to exhaust

administrative remedies. The Court of Appeal affirmed the trial court's summary judgment.

E. *JetSuite, Inc. v. County of Los Angeles*, 16 Cal. App. 5th 10 (2017)

1. On October 10, 2017, the Court of Appeal found the fact that an aircraft touches down in another state, without more, does not mean that the other state has acquired situs over the aircraft, such that California may no longer tax the full value of the aircraft. The Court of Appeal affirmed the trial court judgment imposing tax on the full value.

F. *Williams & Fickett v. County of Fresno*, Cal. Supreme Ct., Case No. S224476 (2017)

1. In general, a party must exhaust available administrative remedies as a prerequisite to seeking relief in court. An exception is where a tax assessment is "a nullity as a matter of law." The issue is whether the nullity exception applies when an assessment on nonexempt property is challenged on the ground that the taxpayer does not own the property involved.

2. On June 5, 2017, the Supreme Court held that the taxpayer must seek an assessment reduction through the administrative assessment appeal process or obtain a stipulation that such proceedings are unnecessary, prior to filing a refund suit in court. The Court gave its ruling prospective effect only, because the plaintiff could reasonably have relied on the Court's decision in *Parr-Richmond v. Boyd* (1954) in opting not to pursue an administrative appeal.

G. *Weatherford v. City of San Rafael*, Cal. Supreme Ct., Case No. S219567 (2017)

1. On June 5, 2017, the Supreme Court ruled that an individual is not required to pay property tax to have standing to pursue legal actions enjoining improper expenditures by local government. It is sufficient for a plaintiff to allege she or he has paid, or is liable to pay, to the defendant locality a tax assessed on the plaintiff by the defendant locality.

H. *Dyanlyn Two v. County of Orange*, 234 Cal. App. 4th 800 (2015)

1. On February 23, 2015, the California Court of Appeal held that a series of transactions which resulted in the sale of a retail shopping center to a long-term lessee was not a change of ownership that triggered a property tax reassessment.

2. The Court rejected the application of the step transaction doctrine to collapse the transactions into a single transaction.

I. *Ocean Avenue LLC v. County of Los Angeles*, 227 Cal. App. 4th 344 (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.

J. *EHP Glendale, LLC v. County of Los Angeles*, California Court of Appeal, Second Appellate District, Case No. B244494 (2013) (not published).

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.

K. *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.

L. *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 APA.

M. *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.

N. *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.

O. Interested Parties Process: Change in Ownership – Rescission

1. On May 29, 2018, the SBE initiated a project to summarize the various written SBE opinions that address a property owner's ability to rescind a recorded deed that triggered a reassessable change in ownership and the property tax effect of such a rescission.

P. 2017-2018 Legislative Session

1. Assembly Bill 1817, signed into law on June 27, 2018, transfers authority to administer programs relating to change in control and change in ownership of a legal entity, along with other programs, from the CDTFA to the SBE.

2. Assembly Bill 1520 was introduced which contained language that could have required a property tax surcharge. Such language was removed and AB 1520 has been approved and chaptered.

3. Assembly Concurrent Resolution 247 was introduced on May 31, 2018, to reaffirm the Assembly's support for Proposition 13. The committee refused adoption on July 2, 2018.

4. Senate Resolution 113 was introduced on June 13, 2018, to reaffirm the Senate's support for Proposition 13. Senate Resolution 113 failed passage in committee on August 15, 2018.

Q. 2015-2016 Legislative Session

1. Senate Bill 259 and Assembly Bill 1040 have been introduced regarding the definition of "change of ownership" for property tax purposes. The bills are similar to AB 2372, which was introduced but failed to advance in the previous session to change the result reached in *Ocean Avenue*.

2. An effort to put a split roll initiative on the ballot in November 2016 was dropped. A placeholder bill was introduced to enact split roll legislation.

XIII. Special Taxes/Fees

A. In 2010, voters approved Proposition 26 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. *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.

C. Other cases challenging the validity of taxes and fees under Proposition 26

1. *California Taxpayers Association v. California Governor's Office of Emergency Services*, Sacramento Superior Court, Case No. 34-2016-80002357 (pending case over issue whether a charge on rail shipments of hazardous materia§l commodities (SB 84) is a "tax" under Proposition 26 and thus is invalid because it failed to obtain the requisite two-thirds supermajority approval of the Legislature). Case has been stayed pending final judgment in a federal case enjoining implementation of SB 84. See XIII.F., below.

2. *California Cannabis Coalition v. City of Upland*, Cal. Supreme Court, Case No. S234148 (case involving issue whether a tax imposed by a proposed local initiative measure is subject to the California constitutional requirements applicable to taxes imposed by a local government).

   a. On August 28, 2017, the Court ruled that local tax ballot measures are not subject to a two-thirds vote requirement but may be passed with a simple majority.

   b. A petition for rehearing was denied on November 1, 2017.

3. *Citizens for Fair REU Rates v. City of Redding*, Cal. Supreme Court, Case No. S224779 (case involving issue whether a payment in lieu of taxes transferred from the city utility to the city general fund is a tax under Proposition 26). On August 27, 2018, the California Supreme Court held the transfer is not a tax under Proposition 26, finding the rate charge did not exceed the reasonable costs of providing electrical services.

4. *Howard Jarvis Taxpayers Assn. v. California Dept. of Forestry and Fire Protection*, Sacramento Superior Court, Case No. 34-2012-00133197-CU-MC-GDS (class action involving the Fire Prevention Fee enacted by AB X1 29). The superior court dismissed the case, and plaintiff filed a Notice of Appeal on March 1, 2018.

5. *Eck v. City of Los Angeles*, Los Angeles Superior Court, Case No. BC577028 (class action challenging City's electric utility fees). The parties settled.

6. *N. California Water Ass'n v. State Water Res. Control Bd*., Court of Appeals, Third Appellate District, Case No. C075866 (water fee imposed on permit and license holders was a valid regulatory fee and not an unlawful tax). A petition for a writ of certiorari was filed, and a response is due September 17, 2018.

7. *Howard Jarvis Taxpayers Assn*. v. City and County of San Francisco, Case No. CGC-18-568657 (plaintiffs contend that Proposition C, which would authorize a gross receipts tax starting January 1, 2019, is a special tax that requires a two-thirds vote).

8. *Johnson v. City of Mendocino*, 25 Cal. App. 5th 1017 (2018) (tax on commercial cannabis businesses was not a special tax subject to two-thirds approval).

D. *California Chamber of Commerce v. California Air Resources Board*, 10 Cal. App. 5th 604 (2017).

1. On April 6, 2017, the Court of Appeal held that California's cap-and-trade auction system was not a "tax" subject to the two-thirds supermajority approval of the Legislature.

2. On June 28, 2017, the Supreme Court denied a petition for review.

E. *Jacks v. City of Santa Barbara*, Cal. Supreme Ct., Case No. 225589 (2017)

1. Pursuant to an agreement between the city and an electricity supplier, the supplier passed on to customers an additional charge equal to one percent of the supplier's gross receipts, purportedly for the use of city property in connection with the delivery of electricity.

2. On June 29, 2017, the Supreme Court held that the surcharge was not a tax but a franchise fee and thus valid under Proposition 218 without requiring voter approval.

F. *BNSF Railway Company v. California Department of Tax and Fee Administration*, No. 16-17130 (9th Cir., Sept. 13, 2018)

1. The United States Court of Appeal affirmed a district court's injunction preventing implementation of SB 84, which requires railroads to collect fees from customers shipping certain hazardous materials. The Court of Appeal held that SB 84 was preempted under the Interstate Commerce Commission Termination Act because of the direct effect on rail transportation.

XIV. **Local Taxes**

A. *926 North Ardmore Avenue, LLC v. County of Los Angeles*, Cal. Supreme Ct., Case No. S222329

1. In 2014, Court of Appeal 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.

3. On January 14, 2015, the California Supreme Court granted the taxpayer's petition for review. Oral arguments were heard on April 5, 2017.

4. On June 29, 2017, the Court affirmed, holding that ownership changes of a legal entity for property tax purposes triggered the documentary transfer tax.

5. On August 9, 2017, the Court denied a petition for rehearing.

B. *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.

C. *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.

D. San Francisco Business Tax

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

a. The 1.5 percent payroll expense tax rate will be reduced by 10 percent, 25 percent, 50 percent, and 75 percent in 2014 through 2017, respectively, and was supposed to be fully phased out by 2018. These phase-outs were subject to modification depending on the amount of revenue generated by the new gross receipts tax. Due to lower amounts of revenue generated by the gross receipts tax, the payroll expense tax remains in place.

(1) The SF Controller has certified and published the payroll expense tax rate for tax year 2017 on August 25, 2017 at 0.711 percent. The payroll expense tax rate was scheduled to be 0.375 percent, but was adjusted upwards because of less-than-expected gross receipts tax revenues. By way of comparison, the 2016 payroll expense tax rate was scheduled to be 0.75 percent, but was adjusted upwards only modestly to 0.829 percent as a result of gross receipts tax revenue shortfalls.

b. Originally, 10 percent, 25 percent, 50 percent, and 75 percent of the authorized gross receipts tax rates was to be imposed in 2014 through 2017, respectively, and was supposed to be fully phased in by 2018. These rates were subject to modification depending on the amount of revenue generated by the gross receipts tax. As noted above, due to lower amounts of revenue generated by the gross receipts tax, the payroll expense tax remains in place.

2. Payroll Expense Tax

a. Generally imposed at 1.5 percent of total payroll attributable to the City.

(1) Taxable payroll includes distributions to owners of pass through entities for services performed in the City, but does not include distributions that are a return on capital investment. See *Coblentz, Patch, Duffy and Bass LLP v. City and County of San Francisco*, 233 Cal.App.4th 691 (2014).

b. Incentives – Enterprise Zone Tax Credit (SF Code § 906A); Biotechnology Exclusion (SF Code § 906.1); Clean Technology Business Exclusion (SF Code § 906.2); Central Market Street and Tenderloin Area Exclusion (SF Code § 906.3); Stock-Based Compensation Exclusion (SF Code § 906.4).

(1) By ordinance, many (but not all) of these incentives require taxpayer's to file timely tax returns and provide the City advanced notice of claiming the incentive to maintain eligibility.

(2) In Regulation 2016-3, the City has taken the position that taxpayers are ineligible for <u>any</u> of these incentives if they do not file timely returns and provide the City advanced notice of claiming the incentive.

3. Gross Receipts Tax

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

b. Taxable gross receipts is defined broadly to include all gross receipts from whatever source derived, including amounts that constitute gross income for federal income tax purposes.

c. Exclusions from taxable gross receipts include:

(1) Certain types of investment income and distributions from business entities;

(2) taxes required to be collected and remitted to the government;

(3) gifts and certain grants;

(4) receipts from sales of real property in which the Real Property Transfer Tax has been paid to the City; and

(5) the costs to acquire real property and financial instruments.

d. Allocation/apportionment methodologies include:

(1) a single payroll factor apportionment method;

(2) a market-based receipts allocation method; and

(3) a blended payroll apportionment and receipts allocation method.

e. The gross receipts tax is imposed on corporate and pass through entities.

f. Combined reporting is generally required for unitary businesses required to file combined California Income/Franchise Tax returns.

(1) It is unclear how pass-through entities are included in a combined gross receipts tax return.

g. The San Francisco Office of the Treasurer and Tax Collector has issued gross receipts tax regulations.

(1) Regulation 2014-1: Interpretations of the former San Francisco gross receipts tax that was repealed in 2001 will not apply to the current gross receipts tax.

(2) Regulation 2014-2: Single-member entities (including single-member LLCs) that are disregarded for federal income tax purposes will be disregarded for purposes of the gross receipts tax, the payroll expense tax, and any business registration requirements. The owner of the disregarded entity will be the registrant and taxpayer for purposes of the above.

(3) Regulation 2014-3: Clarifies the definition of gross receipts subject to tax as applied to a person acting as an agent on behalf of a principal.

(4) Regulation 2016-1: Gross receipts from the sale of real property are excluded from tax where the City's Real Property Transfer Tax was paid with respect to that particular sale by December 31 of the tax year in which the gross receipts at issue would otherwise be subject to the gross receipts tax.

(5) Regulation 2016-2: Construction contractors may reduce gross receipts subject to tax by amounts paid to subcontractors for services performed in the City, so long as the subcontractor has a valid City business registration certificate during the year the services were rendered.

h. Assembly Bill 1184, signed into law on September 21, 2018, authorizes the City and County of San Francisco to impose a tax on autonomous vehicle rides, subject to voter approval requirements.

i. Two local measures addressing gross receipts tax will be featured on the November 2018 ballot.

(1) Proposition C would levy an additional gross receipts tax on corporate revenues greater than $50 million to fund homelessness.

(2) Proposition D would tax cannabis businesses with gross receipts over $500,000 at a rate between 1 percent and 5 percent.

4. San Francisco Business Tax Procedural Issues

a. Legislation enacted in 2017 permits taxpayers to credit business tax overpayments to the following tax period. Prior to this legislation, taxpayers with overpayments of business tax were required to claim a refund of the overpayment. SF Code § 6.9-3(a)(4)(B).

b. The statute of limitations for assessments is generally 3 years from filing. SF Code § 6.11-2(a).

c. The statute of limitations for refund claims is generally 1 year from payment. SF Code § 6.15-1(a).

d. There are no special statute of limitation provisions for assessments or refunds where California or federal adjustments have been made.

5. Local Income Tax

a. On March 21, 2017, the San Francisco Board of Supervisors adopted a resolution urging the California Legislature to (1) amend RTC § 17041.5 to remove the prohibition against California cities levying a personal income tax and (2) enact legislation to permit California cities to levy a corporate income tax.

6. Transient Occupancy Tax

a. On May 23, 2018, the Court of Appeal affirmed the trial court's judgment that online travel companies are not liable for the transient occupancy tax because they are not "operators" under the city's ordinance. *In re Transient Occupancy Tax Cases*, No. B253197 (Cal. Ct. App., May 23, 2018).

E. Other City Business Taxes

1. On June 10, 2016, a taxpayer filed a petition for a writ of certiorari with the U.S. Supreme Court, regarding the issue whether a penalty assessed with the City of Los Angeles business tax is a "tax" for purposes of the Tax Injunction Act. The petition was denied on October 12, 2016. *Huang v. City of Los Angeles*, USSC Docket No. 15-1507.

2. A coalition of over 40 California cities considered adopting an administrative ruling that would subject streaming video services to those cities' utility user taxes.

a. AB 252 was introduced to prohibit California cities and counties from subjecting streaming video to local taxes until January 1, 2023.

b. On April 24, 2017, the Assembly Committee on Revenue and Taxation voted to postpone AB 252 for at least one year.

c. On January 31, 2018, AB 252 died.

3. The City of Cupertino proposed an employee "head tax," patterned after the Seattle head tax, but the Cupertino City Council decided on July 31, 2018, to wait until 2020 before putting the tax proposal before voters.