CALIFORNIA UPDATE

Financial Institutions State Tax Coalition
Annual Meeting
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AGENDA

FEDERAL TAX REFORM

APPORTIONMENT

BUSINESS/NONBUSINESS INCOME

COMBINED REPORTING

RESEARCH AND DEVELOPMENT CREDITS

NEXUS

SALES/USE TAXES

TAX ADMINISTRATION REFORM

CITY TAXES

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FEDERAL TAX REFORM

- California – A Selective Conformity State
  - No automatic conformity to changes made to the Internal Revenue Code (IRC)
  - Currently, California conforms to the IRC as of January 1, 2015
- Deemed Repatriation
  - No current conformity to IRC § 965
  - For water's edge purposes, Subpart F income means "Subpart F income as defined in IRC § 952"
  - Inclusion ratio numerator not affected by IRC § 965 amendments
- Actual Repatriation
  - No conformity to IRC § 245A
  - Dividend deductions depend on whether filing on a worldwide or water's edge basis
    - Full elimination of unitary dividends under Revenue and Taxation Code (RTC) § 25106
    - 75% deduction under RTC § 24411
      - Foreign investment interest offset under RTC § 24344
    - Inclusion ratio issues with respect to Subpart F income

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FEDERAL TAX REFORM

- Global Intangible Low-Tax Income (GILTI)
  - No conformity to IRC § 951A
  - Depends on whether worldwide or water's edge
  - No changes to IRC § 952
  - Is GILTI a dividend?
  - Apportionment formula issues
- Foreign Derived Intangible Income (FDII)
  - No conformity to IRC § 250
- Interest Expense Limitation
  - California conforms to prior version of IRC § 163(j)
    - No automatic conformity to amendments to IRC § 163(j)
    - Compare RTC § 25116
  - California has two expense attribution type statutes that are applied to limit interest deductions
    - RTC § 24425 – expenses disallowed where they were incurred for the primary purpose of providing non- taxable income
    - RTC § 24344 – foreign investment interest offset – interest expense incurred for the purposes of foreign investment may be disallowed
- Limitation on SALT Deductions
  - California did not pass SALT Cap workaround legislation

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APPORTIONMENT/SALES FACTOR

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

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APPORTIONMENT/SALES FACTOR

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

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APPORTIONMENT/SALES FACTOR

- Broker-Dealer Activities
  - If a broker-dealer is unitary with a bank should the broker-dealer's gross receipts be included in the sales factor?
  - This is a very active and controversial issue
  - A number of cases are pending or have been settled
  - *UBS AG and Combined Affiliates*, OTA Case No. 18011773 (2018)
  - What is the effect of *Merrill Lynch* (1989)?
  - What is the effect of *Fuji Bank* (2000)?
  - Is a broker-dealer a financial corporation?

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APPORTIONMENT/SALES FACTOR

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

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APPORTIONMENT/SALES FACTOR

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

APPORTIONMENT/MANDATORY SINGLE SALES FACTOR

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

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APPORTIONMENT/SOURCING OF SALES

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

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ALTERNATIVE APPORTIONMENT

- On June 15, 2017, the 3-member FTB denied an RTC § 25137 petition by Philip Morris USA, Inc. and its Unitary Affiliates to use an alternative apportionment method consisting of a payroll, sales and double-weighted property factor instead of the standard single sales factor apportionment formula for its 2013 tax year
- Second Interested Parties Meeting scheduled for November 26, 2018 to insider potential amendments to Regulation 25137 pertaining to hearings before the 3-member FTB on RTC § 25137 Petitions
- Requests by taxpayers or FTB staff to use a variance now are reviewed by the FTB's 25137 Committee
- Taxpayers and their representatives are now permitted to make oral presentations before the FTB 25137 Committee in support of petitions for relief and in opposition to staff's request
  - FTB Notices 2017-05 and 2018-02

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BUSINESS / NONBUSINESS INCOME

- *ComCon Production Services v. FTB,* Court of Appeal No. B259619, 2016 Cal. App. Unpub. LEXIS 9078 (2016)
  - Trial court held that termination fee received in connection with a failed merger was business income
  - Trial court also held that Comcast and QVC were not engaged in a unitary business
  - Court of Appeal affirmed in unpublished opinion

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BUSINESS / NONBUSINESS INCOME

- *Fidelity National Information Services v. FTB,* No. C081522, 2017 Cal. App. Unpub. LEXIS 5148 (2017)
  - Sale of minority stock interest
  - Trial court held the gain was business income
  - In an unpublished opinion, Court of Appeal reversed and remanded case back to the trial court to determine whether the stock was a business asset when decision was made to sell it
  - On remand, trial court again found the gain to be business income
  - After appeal filed, case was dismissed in 2018

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BUSINESS / NONBUSINESS INCOME

- *Bank of America Corp.,* SBE Case No. 983272 (2017)
  - On November 14, 2017, the SBE held that dividends received by the Bank from one of its Chinese affiliates was nonbusiness income because of lack of integration and interwoven ties between the affiliates
  - FTB filed petition for rehearing
- *Levi Strauss,* SBE Case No. 54705 (2013)
  - SBE appeal involving issue whether interest and other expenses incurred in connection with a leveraged buy out of a California corporation's stock were nonbusiness expenses wholly allocable to California
  - Case settled prior to the SBE hearing
- *Esprit de Corp.*, SBE Case No. 48986 (2001)
  - SBE held that LBO interest expense was a nonbusiness expense wholly allowable to California

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BUSINESS / NONBUSINESS INCOME

- *Leslie's Holdings, Inc.,* SBE Case No. 955278 (2017)
  - On November 15, 2017, the SBE held that 84 percent of interest expense incurred as a result of borrowing to conduct a corporate reorganization was a nonbusiness expense allocated the taxpayer's commercial domicile in Arizona
  - Remaining 16 percent was held to be an apportionable business expense because it was attributable to borrowing to make distributions to employees

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COMBINED REPORTING

- *Harley Davidson, Inc. v. FTB*, 27 Cal.App.5th 245 (2018)
  - Case involves issue whether FTB improperly discriminates against multistate unitary corporate taxpayers by requiring combined reporting and not allowing them to choose separate reporting
  - Court of Appeal held that since there is a legitimate state interest to accurately measure and tax all income, California can require interstate unitary businesses to use combined reporting
- Excess Inclusion
  - FTB Legal Ruling 2009-01 addressed how excess inclusion is determined for a Non-Economic Residual Interest Holder (NERI) in a Real Estate Mortgage Investment Conduit (REMIC) in a combined report
  - FTB Information Letter 2009-01 addressed the application of the excess inclusion rules to non-NERI members of a combined report
  - 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 percentage

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RESEARCH & DEVELOPMENT CREDITS

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

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RESEARCH & DEVELOPMENT CREDITS

FTB is somewhat following federal determinations

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

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CREDIT ASSIGNMENT

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

NEXUS/DOING BUSINESS

- Under RTC § 23101, “doing business” expanded for tax years beginning on or after January 1, 2011
  - Economic nexus
  - Factor-based presence
    - Sales in California exceed lesser of $583,867 or 25% of taxpayer’s total sales
    - Real property and tangible personal property in California exceeds lesser of $58,387 or 25% of taxpayer’s total property
    - Payroll in California exceeds lesser of $58,387 or 25% of taxpayer’s total payroll

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NEXUS/DOING BUSINESS

- *Swart Enterprises v. FTB*, 7 Cal.App.5th 497 (2017)
  - Case involved issue whether a corporate taxpayer is doing business in California and subject to the minimum tax solely through its .2 percent membership interest in a California LLC
  - Court of Appeal concluded that the taxpayer was not doing business in California
- Legal Ruling 2014-01
  - While *Swart* was pending, the FTB issued Legal Ruling 2014-01
  - Business entity held to be doing business in California merely by holding a membership interest in an LLC that is doing business in California
- *Bunzl Distribution v. FTB*, 27 Cal.App.5th 986 (2018)
  - Case involved 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
  - On September 28, 2018, the Court of Appeal issued a published opinion in favor of the FTB and held that the non-resident corporate member of the LLC had nexus
  - The Court rejected the taxpayer's argument that RTC § 18633 and RTC § 23038 barred the use of the UDITPA apportionment formula
  - The Court also distinguished *Swart*

NEXUS/DOING BUSINESS

- Legal Ruling 2018-01
  - Modifies Legal Ruling 2014-01
  - If an LLC is treated as a partnership for tax purposes, both the LLC and its members are subject to the same legal principles applicable to any partnership
  - If the LLC is doing business in California under RTC § 23101, the members themselves are generally considered to be doing business in California
  - A narrow exception (*Swart*) may apply in limited circumstances
- *Harley Davidson v. FTB*, 237 Cal.App.4th 193 (2015)
  - Case involved issue whether certain special purpose entities (SPEs) formed to securitize loans originated by affiliates were taxable in California
  - Case potentially raised issue of applicability of the immunity provisions for foreign lending institutions under Corporations Code § 191(d)
  - Court of Appeal held that although the SPEs had no physical presence in California, they had nexus due to the in-state activities conducted by their affiliate, as agent of the SPEs

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SALES/USE TAXES

- Response to *South Dakota v. Wayfair, Inc.*, 138 S.Ct. 2080 (2018)
  - U.S. Supreme Court overruled the "physical presence" requirement as "unsound and incorrect" and held that substantial nexus is satisfied when an out-of-state seller has sufficient "economic and virtual contacts" with the state
  - South Dakota law required cumulative sales of $100,000 or individual sales transactions of 200 or more in the current or prior year
  - Legislation was proposed in August 2018, but never introduced
  - The California Department of Tax and Fee Administration (CDTFA) will likely be issuing a notice by the end of December
    - Will rely on California 2012 legislation which contains a "long-arm" provision that imposes a duty to collect use tax on retailers with substantial nexus in the state to the extent allowed under the Commerce Clause

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SALES/USE TAXES

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

TAX ADMINISTRATION REFORM

- Taxpayer Transparency and Fairness Act of 2017 (AB102)
  - Enacted on June 27, 2017
  - Eliminated 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
    - SBE continues to administer and hear all tax appeals only for property, insurance and alcoholic beverage taxes
  - On July 1, 2017, the newly created CDTFA began administering sales and other excise taxes
  - On January 1, 2018, tax appeals for income and sales and use taxes began being heard by the newly created Office of Tax Appeals (OTA)
    - Cases heard by panels of three administrative law judges (ALJs)
      - ALJs designated by the director of the OTA, who is appointed by Governor
  - Tax appeals panels required to issue written opinions in all appeals
  - Hearings are generally required to be conducted under the Administrative Procedures Act
  - Regulations have been proposed setting forth the procedural rules for appeals

CITY TAXES

- San Francisco Business Tax
  - Combination of Payroll Expense Tax and a Gross Receipts Tax
  - Worldwide/water's edge unitary tax at local level
  - Proposition C
    - Passed November 6, 2018
      - Would levy an additional gross receipts tax on corporate revenues greater than $50 million to fund homelessness
      - May be subject to challenge since did not obtain 2/3 voter approval
- Head Taxes
  - City of Cupertino proposed an employee "head tax " patterned after the Seattle head tax – aimed at Apple
    - City Council decided on July 31, 2018, to wait until 2020 before putting the tax proposal before voters
  - On November 6, 2018, the voters of the City of Mountain View passed a "head tax" to fund transportation issues – aimed at Google

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Questions

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