State & Local Tax INSIGHTS

MoFo MORRISON & FOERSTER LLP

MITCHELL A. NEWMARK AND PILAR M. SANSONE, CO-EDITORS
SPRING 2004

STATE & LOCAL TAX GROUP

SAN FRANCISCO

Thomas H. Steele	(415) 268-7039 tsteele@mofo.com
Charles J. Moll III	(415) 268-7045 cmoll@mofo.com
Peter B. Kanter	(415) 268-6005 pkanter@mofo.com
Andres Vallejo	(415) 268-6793 avallejo@mofo.com
Pilar M. Sansone	(415) 268-6125 psansone@mofo.com
Troy M. Van Dongen	(415) 268-6721 tvandongen@mofo.com
William H. Weissman	(415) 268-6317 wweissman@mofo.com

DENVER

Thomas H. Steele	(303) 592-2243 tsteele@mofo.com

NEW YORK

Paul H. Frankel	(212) 468-8034 pfrankel@mofo.com
Hollis L. Hyans	(212) 468-8050 hhyans@mofo.com
Craig B. Fields	(212) 468-8193 cfields@mofo.com
Irwin M. Slomka	(212) 468-8048 islomka@mofo.com
Michael A. Pearl	(212) 468-8135 mpearl@mofo.com
Amy F. Nogid	(212) 468-8226 anogid@mofo.com
Roberta Moseley Nero	(212) 506-7214 rnero@mofo.com
Mitchell A. Newmark	(212) 468-8103 mnewmark@mofo.com
David A. Agosto	(212) 468-8125 dagosto@mofo.com
R. Gregory Roberts	(212) 336-8486 rroberts@mofo.com
Behir A. Sabban	(212) 336-8643 bsabban@mofo.com

SACRAMENTO

Eric J. Coffill	(916) 325-1324 ecoffill@mofo.com
Carley A. Roberts	(916) 325-1316 croberts@mofo.com

WASHINGTON DC

Linda A. Arnsbarger	(202) 887-1598 arnsbarger@mofo.com

California Tax Court: It's Time To End "Pay-to-Play" In California

By Paul H. Frankel, Charles J. Moll III, & William H. Weissman

In 1992, distinguished UCLA Law School Professor Michael Asimow, an expert on California administrative law, observed in a law review article, "to put it charitably, California's present arrangement for adjudicating tax cases is a patchwork that can only be understood as a series of historical accidents; to put it less charitably, the system is a mess."[1] Things have not improved in the last 12 years, and California still finds itself in a minority of states that place responsibility for collecting taxes and adjudicating tax disputes in the hands of the same agency.

Indeed, California was ranked among the bottom five states in *every* category of *CFO Magazine's* annual state tax survey, causing "no state to come near California's dismal ranking."[2] More specifically, California was rated as being among the "least desirable" when it came to determining the impact of a state's revenue department policies and systems on a company's decision to locate

INSIDE

or expand in the state, and "least independent" when rating the independence of the state's administrative appeal process from the audit department.

Taxpayers have two basic concerns when it comes to the adjudication of their tax disputes: they want (1) due process in the form of a fair, impartial tax hearing that is separate from the tax collection function; and (2) the ability to contest alleged deficiencies without the heavy burden of prepaying the tax, a requirement commonly referred to as "pay-to-play." Creating an independent tax adjudication system that does not require taxpayers to "pay-to-play" would go a long way toward improving the perception of California as a fair and decent place to live and do business.

Where we are today

Currently, California taxes are administered and collected by various administrative agencies, including the Franchise Tax Board ("FTB"), the State Board of Equalization ("SBE"), and the Employment Development Department ("EDD"). In general, the FTB administers corporate franchise taxes and income taxes, while the SBE administers sales and use taxes, state-assessed property taxes, and a myriad of other "special" taxes (*e.g.*, cigarette taxes, environmental taxes, fuel taxes, and insurance taxes). The SBE also hears taxpayer appeals of the taxes administered by the FTB. The EDD primarily administers employment taxes.

Typically, an aggrieved taxpayer who seeks to appeal a final decision of one of these revenue collection agencies must first pay the tax, and then file a suit for refund in Superior Court. Thus, unlike federal taxpayers and taxpayers in most other states, California taxpayers must pay their tax before having their "day in court" before a tribunal other than the tax collection agency. This is true regardless of the size or propriety of the proposed liability.[3]

How we got to where we are today

To understand where we are today, and why an independent tax court is needed in California, a brief history lesson is helpful. The SBE was created in 1872 to equalize property taxes across the state. At the time it was formed, there were no personal or corporate income taxes, no sales and use taxes, and few specialized taxes. When the Bank and Corporation Franchise Tax Act was originally enacted in 1929, the SBE and the State Controller both sought to administer the new tax. A compromise was reached whereby a new Franchise Tax Commissioner was to be appointed by the Chairman of the SBE, the State Controller, and the Director of Finance. A similar struggle ensued in 1935, with similar results, when the personal income tax law was enacted. In 1949, the FTB replaced the office of the Franchise Tax Commissioner. The FTB consisted of the same three officers who formerly had the power to appoint the Franchise Tax Commissioner. Since two of those three FTB members also sit on the five-member SBE, the boards overlap.

The rationale behind California's "pay-to-play" system can be traced back at least to the United States Supreme Court's 1870 decision of *Dows v. City of Chicago*.[4] At the time *Dows* was decided, the states and their municipalities primarily relied upon the payment of property taxes to operate, and did not have the wide variety of income, sales and other taxes that exists today.[5] The ability of states and municipalities to function with such limited funding sources necessitated that they be able to collect taxes in an orderly manner, even if the taxes were subject to challenge. Thus, the rule that a taxpayer must pay a tax in order to contest it served to protect the state from being paralyzed by taxpayers who might contest assessments, even if the taxpayer was in fact, correct.

In the last 70 years, the complexity of the Revenue and Taxation Code, the size of the assessments at issue, and the general nature of business have changed dramatically. Today, approximately 98 percent of personal and corporate income taxes and sales and use taxes paid to California are self-assessed taxes. The concerns about the uninterrupted operation of government expressed in *Dows* that supported "pay-to-play" no longer apply; today, California simply is not going to collapse if taxpayers with legitimate complaints are able to contest the remaining 2 percent of tax revenues before paying their proposed assessment. The variety of funding sources available to the State further undermines the rationale for "pay-to-play."

Other states have come to realize that this is indeed true. For example, in 1997 then-Massachusetts Revenue Commissioner Mitchell Adams likened his state's "pay-to-play" system as one of "shoot first, ask questions later." The Massachusetts Legislature ended "pay-to-play" in 1999 after recognizing that its tax system was contributing to Massachusetts' bad reputation as a place to do business. Not surprisingly, Massachusetts has not fallen into Boston Harbor, but is alive and functioning well. Other states, such as Tennessee and Florida, have long allowed taxpayers to contest assessments in their civil courts without prepayment if the taxpayer posts a bond. Still others, such as Minnesota, Oregon, and Indiana, provide administrative tax courts that afford prepayment relief. The District of Columbia recently created an independent Office of Administrative Hearings to hear tax appeals from the Office of Tax and Revenue, starting in October 2004. And, of course,

continued as "Tax Court" on page 4

Upcoming Conferences

Following is a list of major open conferences through December 31, 2004, in which Morrison & Foerster attorneys will be participating.

April 26, 2004
Energy Tax Association
New Orleans
Speaker: Craig B. Fields
(cfields@mofo.com)

April 29, 2004
Breakfast Briefing: Microsoft Corp. v. Franchise Tax Board and Other Gross Receipts Cases
San Francisco
Contact: Andres Vallejo
(avallejo@mofo.com), Pilar M. Sansone (psansone@mofo.com)

May 7, 2004
ABA Section of Taxation, State and Local Tax Committee
Washington, D.C.
Speaker: Craig B. Fields
(cfields@mofo.com)

May 13, 2004
Georgetown University State and Local Tax Institute
Washington, D.C.
Speakers: Paul H. Frankel
(pfrankel@mofo.com)

June 22, 2004
Multistate Tax Conference (sponsored by the University of Wisconsin at Milwaukee Business School)
Milwaukee
Speaker: Paul H. Frankel
(pfrankel@mofo.com)

June 23, 2004
Seminar on the U.S. Taxation of International Banks, Sponsored by the Institute of International Bankers
New York City
Speaker: Irwin M. Slomka
(islomka@mofo.com)

July 15, 2004
New York University Annual State and Local Tax Institute
New York City
Speaker: Charles J. Moll III
(cmoll@mofo.com)

July 22, 2004
IPT 2004 Annual Conference
Vancouver, British Columbia
Speaker: Thomas H. Steele
(tsteele@mofo.com)

August 18, 2004
PLI's State and Local Taxation Program
New York City
Chair: Hollis L. Hyans
(hhyans@mofo.com)
Speaker: Craig B. Fields
(cfields@mofo.com)

Fall 2004
Annual Property Tax Conference
San Francisco
Speakers: Thomas H. Steele, Charles J. Moll III, Peter B. Kanter, Troy M. Van Dongen
Contact: Troy Van Dongen
(tvandongen@mofo.com)

October 20, 2004
Chicago Tax Club Fall Seminar
Chicago
Speaker: Paul H. Frankel
(pfrankel@mofo.com)

October 21, 2004
11th Annual Vanderbilt-Paul J. Hartman SALT Forum
Nashville
Speaker: Paul H. Frankel
(pfrankel@mofo.com)

December 2–3, 2004
Institute on State and Local Taxation at New York University
New York City
Co-chair: Paul H. Frankel
Panel chairs: Hollis L. Hyans and Craig B. Fields
Speaker: Thomas H. Steele
Contact: Craig B. Fields
(cfields@mofo.com)

Tax Court, continued from page 3

the United States government has long recognized the efficacy and reasonableness of allowing prepayment contests before impartial judges in the United States Tax Court ("USTC").

The time has come for California to end the unfair practice of requiring taxpayers to "pay-to-play." California needs an independent tax tribunal, staffed with the necessary expertise,

> *The time has come for California to end the unfair practice of requiring taxpayers to "pay-to-play"*

to handle the often complicated tax issues that now face both individuals and businesses across the state.

Who supports the creation of an independent tax court

A wide variety of interests support the creation of an independent tax court as a mechanism to ending "pay-to-play." For example, recently the bipartisan California Commission on Tax Policy in the New Economy, established by Governor Davis to review all state tax issues in light of California's changing economy, unanimously endorsed the creation of a California tax court modeled on the USTC. The very first reason cited by the Commission was the lack of a sufficient prepayment procedure to contest assessments; the Commission further noted that most taxpayers could not afford to "pay-to-play" and thus are "stuck with whatever the SBE or its staff decides."[6] Even the former director of the Multistate Tax Commission, Gene Corrigan, called California's "pay-to-play" system "simply unfair."

Academics support the idea as well. For example, distinguished University of California, Davis Law School Professor Daniel Simmons, who in 1978 was Chair of the California Commission on Government Reform ("Post Commission") that examined conforming California's tax code to the Internal Revenue Code, supports the creation of the tax court along the lines of the highly successful USTC model.[7]

And, of course, taxpayers support the notion of a fair, impartial prepayment body for contesting taxes. Where a tax collection agency also adjudicates the tax, the appearance of a lack of independence is imparted to taxpayers who view the agency as both the prosecutor and the judge.

Why a specialized court for taxes

Some have questioned why a specialized court is needed for taxes when there are few, if any, specialized courts for employment and labor law, environmental law, or other similar highly codified "specialty" areas of law.

There are fundamental reasons why the need for a special court for taxes is different from the need for a special court for other areas of the law. First, nearly all citizens and certainly all businesses must deal with the taxing authorities each and every year, at least once if not quarterly for income taxes, at least once but as often as monthly for sales and use tax, not to mention the other taxes that individuals and businesses must pay. To the contrary, a union employee can work for 40 years and never have to interact with the government with regard to labor issues. Given the frequency with which citizens come into contact with government through the taxing authorities, it is important that such contact be seen as professional and fair.

Moreover, and perhaps more importantly, most of California's taxes are based upon self-assessment by taxpayers. Without widespread adherence to this self-assessment system by California's taxpayers, California's taxes would not be administrable, and the system would collapse.

When a dispute arises, it is important that the resolution be seen as fair and impartial to avoid taxpayers abandoning this system. Where the judge is also the prosecutor, the credibility of the decision, even if correct, is undermined. While the staff of the FTB, the SBE, the EDD, and other state agencies all act professionally and do the best job they can, they can make mistakes, and reasonable differences of opinion can arise between those agencies and taxpayers. Who could possibly be against a fair and impartial process for resolving such disputes?

Finally, taxes traditionally have been the province of two professions: attorneys and accountants. Accountants have been able to represent their clients before proceedings with the IRS and in the USTC, as well as before the state agencies and the SBE for many years. However, accountants are barred from representing their clients in the state civil courts, the only independent avenue currently available to taxpayers in California. By creating a tax court modeled after the USTC, accountants (and others, such as enrolled agents) would be able to continue in their traditional role as representatives for their clients in a fair and impartial tax adjudication system. Thus, a tax court would preserve the important relationship that has long existed between taxpayers and their accountants.

Why the criticisms against a tax court do not stand up to scrutiny

There have been a variety of criticisms made about the current proposals for an independent tax court in California. The first is that this is somehow an attack on the state agencies that currently administer taxes. This is simply untrue. Under the current proposals, no state agency is being abolished or replaced. Indeed, with the exception of appeals from the FTB of personal and corporate income taxes, all other taxes may still be appealed in the same manner as before. The only difference would be that California taxpayers, for the first time, would be afforded the opportunity to seek prepayment review by an independent and impartial tax court judge following the hearing by the collection agency.

Thus, for example, the SBE still will be free to hold hearings on sales and use tax matters, state-assessed property tax matters, and the myriad other taxes that it currently administers, after the creation of an independent tax court. Although some have questioned the efficiency of having five highly paid elected officials all sitting and hearing thousands of cases with tax disputes that average $1,200, this administrative process is important in resolving disputes and reducing the number of cases to be appealed to the tax court.

Second, some people suggest that the SBE is adequate to handle the task and thus a new adjudicative body is unnecessary. However, taxpayers are only afforded 10 minutes to present their case to the SBE, making it impossible to present a complex factual and legal tax case. As a result, taxpayers must engage in *ex parte* communications with SBE members prior to their hearing to explain their case, even though the representatives may be reluctant to do so. Indeed, there has long been debate about the ethical considerations involved in such *ex parte* contacts.

More importantly, in its present form, the SBE is just not equipped to act as a trial court. Some cases involve complex issues and tens of millions of dollars, cover several tax years, and have thousands of pages of documentary evidence. If the SBE was to provide for full evidentiary hearings, the SBE most likely would be required to hold hearings during most business days of the year. This would make it virtually impossible for SBE members to perform their many other required duties.

> *"To preserve the integrity of the self-assessment tax system, taxpayers need and deserve a system that is at least viewed as impartial, where the prosecutor is not also the judge*

Finally, some have questioned

whether modeling a California tax court after the USTC would present procedural difficulties for taxpayers or their representatives. For example, some have observed that the USTC procedural rules are lengthy, and that a qualifications test is required of all non-attorneys. True, the USTC rules are lengthy; but they were specifically designed to include sufficient details about the procedures to make them more understandable to taxpayers, not to complicate them. Moreover, as anyone who has practiced before the USTC can attest to, most proceedings in the USTC are conducted in a manner that is quite informal and are generally well-received by taxpayers. The statistics bear this out — over 70 percent of the total cases docketed at the USTC are *pro se* taxpayers.

Moreover, the qualifications test administered by the USTC exists to protect taxpayers by ensuring that their representatives are qualified to practice. This test should pose little concern to tax professionals. At last count, 7,228 non-attorneys have passed this test and were qualified to represent taxpayers before the USTC.

Conclusion

It is time to end "pay-to-play" in California. Despite the pressure from special interests, such as Capitol insiders, who seek to retain the status quo, California taxpayers need the ability to contest taxes before an independent tribunal that is separate from the tax collection agency, without the heavy burden of prepayment. To preserve the integrity of the self-assessment tax system, taxpayers need and deserve a system that is at least viewed as impartial, where the prosecutor is not also the judge.

Creating an independent tax court modeled on the USTC is one way to provide the necessary due process and a reasonable prepayment method for challenging tax assessments. The State will not collapse under such a system, and it would only improve the perception of California as a fair and reasonable place in which to live and conduct business. California's taxpayers want a fair shake, not a shakedown, and they deserve no less. ■

---

[1] Michael Asimow, *Toward A New California Administrative Procedure Act: Adjudication Fundamentals*, 39 UCLA L. REV. 1067, 1164 n. 334 (1992)

[2] Tim Reason, *The 2004 State Tax Survey*, CFO Magazine (January 2004), *available at* www.lexis.com.

[3] Two bills, A.B. 2472 (Wolk) and S.B. 1424 (Burton), have been introduced in the California Legislature that would create a California tax court. These bills would set the qualifications for, the term of office of, and the manner in which a judge is appointed to the California Tax Court; allow for an appeal before the California Tax Court in lieu of filing an appeal in the California Superior Court; and provide for a review in the Court of Appeal.

[4] 78 U.S. 108 (1870).

[5] According to Professor Lawrence Friedman, about three-fourths of state revenues were generated from property taxes in the late 1800s. *See* Lawrence Friedman, *History Of American Law*, 567 (2nd ed. 1985). In contrast, today property taxes only account for about one-third of California's general fund revenues.

[6] *See* California Commission on Tax Policy in the New Economy, *Final Report* (December 2003), at p. 34.

[7] Letter from Daniel L. Simmons to the California Comm. on Tax Policy in the New Economy, September 23, 2003, reprinted in California Comm. on Tax Policy in the New Economy, Final Report, at pp. 77-83.

Bay Area State & Local Tax Breakfast Meetings

The San Francisco Bar Association's Barristers Club is holding a series of bimonthly breakfast meetings designed to provide a forum for discussing current developments in state and local tax law, as well as an opportunity for the Bay Area's state and local tax community to meet on a regular basis. The first breakfast meeting will feature a discussion of *Microsoft Corp. v. Franchise Tax Board* and other gross receipts cases by the former Chief Counsel of the California Franchise Tax Board. There will be no charge to attend the first meeting. (There will be a charge for the cost of breakfast at future meetings.) One hour of CLE and CPE credit will be provided. All are welcome; please contact Carol Sandona at csandona@mofo.com by April 26, 2004, if you would like to attend. ■

United States Supreme Court Seals Taxpayer Victory in *Farmer Bros.*[1]

By Thomas H. Steele and Andres Vallejo

On February 23, 2004, the United States Supreme Court rejected the petition for certiorari ("Cert. Petition") filed by the California Franchise Tax Board ("FTB") in *Farmer Bros. Co. v. Franchise Tax Board,* 108 Cal. App. 4th 976 (2003), *cert. denied*, No. S117131, 2003 Cal. LEXIS 6515 (Aug. 27, 2003), *cert. denied,* 124 S. Ct. 1411 (Feb. 23, 2004). Thus, the book is closed on Farmer Bros.' successful challenge to the state's discriminatory dividend received deduction ("DRD") statute, *i.e.,* California Revenue & Taxation Code section 24402.[2]

In this article, we review the legal principles that framed the controversy and provide some insight into what lies ahead now that the litigation has been successfully concluded. At the outset, we briefly summarize the background of the litigation and the decision of the California Court of Appeal that was the target of the FTB's Cert. Petition. Thereafter, we summarize the grounds raised by the FTB as its basis for seeking U.S. Supreme Court intervention, including, particularly, the FTB's attempt to convince the Court that the discriminatory DRD should be viewed as a complementary tax imposed upon interstate commerce in compensation for other taxes paid solely by intrastate commerce. Next, we provide a brief response to those arguments drawn largely from the Opposition to Cert. Petition brief filed by Farmer Bros. Whether the debate on the substantive issue had any persuasive effect upon the Court in denying the Cert. Petition is, of course, speculation. Nonetheless, the grounds advanced by the FTB in its Cert. Petition raise some interesting issues worth exploring in their own right, because they shed light upon the nature of proof that a state must advance to meet the requirements of complementary tax defense to an otherwise facially discriminatory tax.

Finally, we address the question of remedies. In this regard, it appears that all taxpayers with valid (timely-filed) claims involving tax years prior to 1999 should expect a refund of the discriminatory taxes collected by the State (albeit with a possible adjustment to disallow as a deduction, expenses attributable to the investment which produced the dividend). In contrast, for taxes paid in 1999 and thereafter, the issue remains very much in play: the FTB apparently intends to deny all DRDs that previously relied upon section 24402 as authority on the theory that section 24402 has now been voided in its entirety by the litigation. Thus, the FTB apparently intends to disallow a deduction for all dividends received by corporate taxpayers regardless of whether those dividends are drawn from income taxed by California or income taxed by other states. In this discussion, we outline arguments that may be available to taxpayers to challenge the FTB's position and/or encourage new legislation, including a brief description of the efforts underway to enact legislation to restore the insurance company DRD which was struck down in earlier litigation.

Background of the Litigation

Farmer Bros., a California coffee manufacturer, received dividends from investments in various companies engaged in business in other states as well as, in some cases, in California. Relying upon section 24402, Farmer Bros. Co. took a deduction for up to 70 percent of the dividends based on its stock ownership in the payor corporations. (The deduction was available in greater percentages as the stock ownership percentage increased.) However, section 24402 limited the deduction to dividends considered to have been paid from income that had previously been subject to California tax (which determination depended upon the dividend payor's relative apportionment factors within the state of California).

Farmer Bros. challenged the limitation placed on the section 24402 deduction as violating the Commerce Clause

—citing among other things, that the statute provides a tax benefit based upon the relative presence of the payor in the state, in violation of the U.S. Supreme Court's ruling in *Fulton Corp. v. Faulkner,* 516 U.S. 325 (1996). The FTB, in turn, countered that the statute did not discriminate against interstate commerce because its purpose was to eliminate double taxation of California income and not to favor in-state commerce. The FTB also argued that the section 24402 scheme, in effect, imposed a "compensatory tax" upon a stream of earnings that originated in other states, and that the imposition of this tax insured that the out-of-state earnings bore a California tax equal to that borne by earnings generated from within the State.

The Court of Appeal Ruling

In holding that the DRD violated the Commerce Clause, the California Court of Appeal relied principally upon three authorities: *Fulton, supra,* 516 U.S. at 327, which struck down a North Carolina "intangibles tax" that taxed "a fraction of the value of corporate stock owned by North Carolina residents inversely proportional to the corporation's exposure to the State's income tax"; *Ceridian Corp. v. Franchise Tax Bd.,* 85 Cal. App. 4th 875 (2000), which struck down a California dividend received deduction for dividends paid by insurance subsidiaries that was closely similar in concept to the DRD at issue in *Farmer Bros.*; and *D.D.I., Inc. v. North Dakota,* 657 N.W.2d 228 (N.D. 2003), which struck down a North Dakota dividends received deduction that apparently mirrored the DRD at issue in *Farmer Bros.* In reliance upon these authorities, the California court held:

> We conclude that section 24402 is discriminatory on its face because it affords to taxpayers a deduction for dividends received from corporations subject to tax in California, while no deduction is afforded for dividends received from corporations not subject to tax in California. As a result, the DRD scheme favors dividend-paying corporations doing business in California and paying California taxes over dividend-paying corporations which do not do business in California and pay no taxes in California. The deduction thus discriminates between transactions on the basis of an interstate element, which is facially discriminatory under the commerce clause.

Farmer Bros., 108 Cal. App. 4th at 986-87.

The Court of Appeal also concluded that the DRD violated the "internal consistency doctrine" because, assuming other states replicated California's DRD, the combined tax burden of the dividend payor and the dividend recipient would be greater if the payor and recipient operated in different states than the tax burden would be if the payor and recipient did business wholly within a single state.

The Denial of the DRD Cannot Be Justified as a Compensatory Tax

After concluding that the DRD constituted facial discrimination against interstate commerce, the Court of Appeal rejected the FTB's argument that the discrimination could be justified because the restriction on the DRD operated to compensate for the fact that in-state commerce (*i.e.*, dividends qualifying for the DRD)

"We conclude that section 24402 is discriminatory on its face …."

previously had borne a California franchise tax while interstate commerce (*i.e.*, non-qualifying dividends) had been exempt from that tax burden. The Court of Appeal first noted three conditions that the U.S. Supreme Court has articulated as necessary to invoke the so-called compensatory tax defense: (1) a state must, as a threshold matter, identify the intrastate tax burden for which the state is attempting to compensate; (2) the tax on interstate commerce must be shown roughly to approximate, but not exceed, the amount of the tax on intrastate commerce; and (3) the events on which the interstate and intrastate taxes are imposed must be substantially equivalent; that is, they must be sufficiently similar in substance to serve as mutually exclusive proxies for each other. *Farmer Bros., supra,* 108 Cal. App. 4th at 989 (citing *Fulton, supra*, 516 U.S. at 332-333).

In applying this test, the Court of Appeal noted that the U.S. Supreme Court has rejected comparisons under the compensatory tax doctrine based simply upon the argument that out-of-state earnings had not been subjected to the state's general income tax. Instead, the U.S. Supreme Court has required a showing that the in-state commerce has borne some specific burden or paid for some benefit for which the state may fairly ask analogous compensation from interstate business. Thus, absent compelling proof that the state's general income tax could be traced to funding a specific program, which was also utilized by the interstate commerce, the Court of Appeal found that it could not "even begin to make the sorts of qualitative assessments that the compensatory tax doctrine requires." *Id.* at 991 (quoting *Fulton, supra,* 516 U.S. at 338). The Court of Appeal also noted that the compensatory tax doctrine would be particularly difficult to satisfy, where, as here, the identified tax burden was imposed at a different level of commerce (the payor level) than the purported compensatory tax.[3]

continued as "Farmers" on page 10

New York City Tribunal Decision in *Toys "R" Us-NYTEX* Confirms Arm's Length Pricing As Key to Combination

By Irwin M. Slomka

The New York City Tax Appeals Tribunal recently issued what may be the most significant taxpayer victory in New York to date on when the New York tax authorities may forcibly combine a corporate taxpayer with an affiliated intangibles holding company. In *Matter of Toys "R" Us-NYTEX, Inc.*, TAT(E) -93-1039(GC) (N.Y.C. Tax App. Trib., Jan. 14, 2004), the New York City Tribunal ("City Tribunal") held that Toys "R" Us-NYTEX, Inc. ("Toys-NYTEX") proved that its transactions with its affiliated intangibles companies—principally royalty payments for the use of trademarks held by Geoffrey, Inc. ("Geoffrey") and interest payments made to affiliated financing companies—were at arm's length rates, thereby overcoming the presumption of distortion. Therefore, New York City could not forcibly combine Geoffrey and the financing companies with Toys-NYTEX for New York City general corporation tax ("GCT") purposes. Most noteworthy was the City Tribunal's clear holding that the proper analysis for New York City combination is not whether there is economic substance and a valid business purpose, but whether the transactions at issue reflect an arm's length charge.

Background

For New York City (and New York State) corporate tax purposes, a taxpayer can be forced to file its returns on a combined basis with a nontaxpayer affiliate only if there is (1) substantial ownership (2) a unitary relationship and, of critical importance, (3) distortion resulting from separate filing, such as by non-arm's length intercompany transactions. The presence of substantial intercorporate transactions creates a rebuttable presumption of distortion. *See* 19 R.C.N.Y. § 11-91.

Facts

Toys-NYTEX, one of several corporations that comprise the Toys "R" Us organization, operates retail toy and children's clothing stores in New York. In 1984, Toys "R" Us underwent a major restructuring, which included the formation of separate corporations, such as Toys-NYTEX, to operate in certain states, and the formation of Geoffrey to hold, protect, and maintain the Toys "R" Us trademarks and trade names ("Marks"). Following the formation of Geoffrey, Toys "R" Us contributed the Marks to Geoffrey in exchange for stock in a nonrecognition transfer pursuant to Internal Revenue Code ("IRC") section 351. As a result, Geoffrey became the registered owner of the Marks. Geoffrey granted a non-exclusive license of the Marks to its retail affiliates, including Toys-NYTEX, in exchange for a royalty based on a percentage of the retail companies' net sales.

continued as "Toys" on page 18

Farmers, continued from page 9

The FTB's Cert. Petition to the U.S. Supreme Court

To a large extent, the FTB's Cert. Petition merely reiterated the arguments made at the Court of Appeal in its unsuccessful attempt to defend the DRD.[4] However, the FTB cast those arguments in slightly different terms in its attempt to convince the U.S. Supreme Court that the case was of sufficient importance to justify the Court's attention.

> *Indeed, a FTB victory on the merits almost certainly would have required the U.S. Supreme Court to overturn* Fulton

As its primary contention, the FTB argued that the Court of Appeal's decision actually discriminated *against* in-state commerce rather than simply requiring equal treatment of interstate commerce. In this regard, the FTB maintained that California had a legitimate interest in alleviating the multiple tax burdens that California, itself, had imposed upon the dividends. The FTB asserted that the State's imposition of a second level tax on receipt of dividend income did not violate any constitutional principle and that such multiple taxation could be eliminated by the State as a matter of tax policy, just as the federal government had chosen to eliminate the double federal corporate income tax burden by Internal Revenue Code section 243's dividends-received deduction.[5]

Placed in this perspective, the FTB argued that the DRD did not discriminate against interstate commerce because the California tax burden borne by both in-state and out-of-state commerce remained the same. To prove its point, the FTB advanced the following hypotheticals:

1) A dividend-payor, Corporation A, earned $100 that was taxed by California. Its California tax on this income is $8.84 ($100 multiplied by the current statutory rate of 8.84%). Corporation A pays a dividend of the after-tax income, $91.16 ($100 – $8.84), to Corporation B. Corporation B receives $91.16 of income. But for section 24402, Corporation B would pay a tax of $8.06 on the receipt of the dividend ($91.16 of income multiplied by the statutory rate of 8.84%). However, section 24402 allows Corporation B to take a deduction of $91.16 with respect to the dividend. Because of the deduction, Corporation B pays no California tax on the dividend. California receives a total tax of $8.84 on the $100 of income earned by Corporation A and paid to Corporation B.

2) A dividend-payor, Corporation C, earned $100 that is not taxed by California. A dividend is paid of the after-tax income, $100 to Corporation D. Corporation D receives $100, which is taxed by California at the statutory rate of 8.84%, and pays California a tax of $8.84. Corporation D does not receive a deduction under section 24402 because the income from which the dividend was paid was not previously taxed by California. Corporation D has after-tax income of $91.16. California receives a total tax of $8.84 on the $100 of income earned by Corporation C and paid to Corporation D.[6]

In addition to arguing that the Court of Appeal's decision was wrong on the merits, the FTB also argued that the U.S. Supreme Court should grant the Cert. Petition in order to "provide necessary guidance"[7] concerning a question that had not previously been addressed by the Court in its opinions: whether in meeting the third prong of the compensatory tax defense (that the complementary taxes fall on "substantially equivalent events"), an income tax imposed upon the operations of a corporation and an income tax imposed upon a shareholder receiving dividends from that operating corporation should be treated (essentially as a matter of law) as imposed upon substantially equivalent events.[8]

Analysis of the Key Arguments Made in FTB's Cert. Petition

It is worth noting that the FTB faced a formidable hurdle in its Cert. Petition. The Court accepts very few cases for review. And, here the FTB faced three decisions by three separate courts — *Ceridian*, *D.D.I.*, and the Court of Appeal's decision — all arriving at essentially the same conclusion.[9] Those decisions, in turn, were based upon a careful reading of the U.S. Supreme Court's unanimous opinion in *Fulton*, which struck down a tax regime that was functionally identical to the DRDs at issue in the state proceedings. Indeed, a FTB victory on the merits almost certainly would have required the U.S. Supreme Court to overturn *Fulton*, and thus the Court's rejection of the Cert. Petition probably requires little further explanation. The FTB did the best it could with a losing cause. Nonetheless, at least a brief response to the FTB's arguments seems worthwhile particularly because it may serve to inform the litigation and legislative effort that are sure to follow.

Reduced to its basics, the FTB's central argument suffered from at least two analytical defects. First, the FTB's postulation of an equal tax burden borne by the stream of both intrastate and interstate earnings (shown in its two hypothetical examples, quoted above) is obviously flawed because it ignores the theory and the reality of taxes imposed by other states. When such taxes are considered, the illusion created by the FTB's hypothetical, described above, is revealed: Corporation C's $100 (which is earned outside of California) is first reduced by the taxes of another state (say Arizona); the remaining earnings, which are then paid as a dividend to a California stockholder, are further reduced by taxes imposed by California. No similar double taxation occurs where the dividend payor and payee are both located entirely within California.[10] So viewed, California's "tax policy" of eliminating double taxation of corporate income creates discrimination against interstate commerce. If it were applied by every state, interstate commerce would be double taxed while in-state commerce would bear a single levy. In other words, if it is good tax policy to eliminate multiple taxation of corporate income, and assuredly it is, then that policy must be applied in a manner that does not discriminate, *i.e.,* it must be extended to accommodate taxes imposed by other states as well.[11]

More fundamentally, the FTB's argument (as demonstrated by its hypothetical) also failed to focus upon the real concern that appears to have motivated the U.S. Supreme Court's decision in *Fulton.* In *Fulton,* the Court focused upon the effect of the North Carolina tax upon the behavior of a potential investor considering an investment in the stock of a North Carolina corporation versus investment in the stock of a corporation doing business in another state. So viewed, the North Carolina tax created pressure to invest in the home-state securities because the investor would pay an intangibles tax on his or her out-of-state securities, but avoid that tax on North Carolina securities. Similarly, the California DRD essentially imposed a discriminatory income tax on the owner of out-of-state stock (which paid a dividend) while the owner of stock in California companies paid no such tax. Even if one ignores the FTB's failure to acknowledge taxes imposed by other states on the operating companies in its hypothetical, the FTB's example is nonetheless flawed: it proceeds on the assumption that the burden of the tax imposed upon the operating company, in fact, is borne by the stockholder in the form of a dollar-for-dollar reduction in the amount of the dividend received. Put another way, had the operating company paid the California

"[I]f it is good tax policy to eliminate multiple taxation of corporate income, and assuredly it is, then that policy must be applied in a manner that does not discriminate

tax of $8.84 (assumed in the hypothetical) on its earnings and still declared a $100 dividend (rather than a dividend reduced by that amount of tax), then an investor in a California company's stock would receive $100, virtually all of which would be deductible for California purposes.[12] In contrast, the investor in a company doing all of its business in another state would not receive any deduction for the dividend received.

The FTB's desire to gloss over this assumption explains, in part, the purportedly "unaddressed" question posed by the FTB in the Cert. Petition, namely whether an income tax imposed upon the operations of a corporation and an income tax imposed upon a shareholder receiving dividends from that operating corporation should be treated (essentially as a matter of law) as imposed upon substantially equivalent events. In other words, only if one is willing to make that assumption (essentially as a matter of law) can one conclude that the tax burden on the investor is necessarily the same when his or her investment involves a California corporation versus an investment in an out-of-state corporation.

As the U.S. Supreme Court observed in *Fulton,* determining whether two taxes imposed upon different taxpayers at different levels should be treated as imposed upon a substantially equivalent event, is a "complex factual inquir[y]" that courts "are poorly equipped to evaluate with precision" because the question, at bottom, is whether the economic incidence of a tax should be treated as different than the normal incidence of that tax. *Fulton, supra*, 516 U.S. at 341-342 (citations omitted). For example, determining whether a tax imposed upon an operating company should be viewed as borne by its shareholders (because its effects are passed through) may turn upon whether the operating company has sufficient market power to pass the tax to its customers in the form of a price increase, rather than to its shareholders. The *Farmer Bros.* appeal lacked both the factual record and any expert analysis upon which to evaluate whether the two taxes described in the FTB's hypothetical were imposed upon the same class of taxpayers (*i.e.,* the recipient of the dividend). Thus, there would appear to have been no basis upon which the FTB could have established its claim that the DRD satisfied the compensatory tax defense, because the FTB could never have satisfied the third prong of the test, *i.e.,* proof that the two taxes in question were imposed upon substantially equivalent events.

No Ruling on Remedies

In regard to the matter of remedies, neither the Court of Appeal opinion, nor the Cert. Petition addressed the issue for the simple reason that the FTB had not appealed the trial court's order that Farmer Bros. was entitled to receive a refund of the tax paid as a consequence of the discriminating limits on the DRD. The FTB's decision not to appeal may be traced to its realization that the statute of limitations on all of the years at issue in *Farmer Bros.* would be closed before the final resolution of the case. Thus, while the U.S. Supreme Court's decision in *McKesson Corp. v. Division of Alcoholic Beverages & Tobacco,* 496 U.S. 18 (1990), provides a theoretical foundation for remedying discrimination either by granting a refund to the interstate commerce that suffered the discrimination or by increasing the tax on the favored intrastate commerce, that choice would not have been available in *Farmer Bros.* Indeed, by the time the U.S. Supreme Court denied the Cert. Petition, the general statute of limitations for corporate taxpayers had closed not only for the years at issue in the litigation (1998 and prior years) but was on the verge

"[I]t appears that the FTB intends to take the position that section 24402 as a whole is void and taxpayers may no longer claim the benefits or suffer the detriments of the deduction

of closing for an additional tax year just weeks after the Court's decision. In any event, the FTB's decision not to appeal was an acknowledgement that it would not be in a position to tax the favored commerce and that refunds to the disfavored commerce were therefore appropriate. *See Ceridian Corp. v. Franchise Tax Bd.,* 85 Cal. App. 4th 875 (2000) (where the statute of limitations bars any assessment of additional tax from the favored class of taxpayers, the only permissible remedy is a refund).

Implications for the Future

Based upon the FTB's reaction to the *Ceridian* litigation, it appears that the FTB intends to take the position that section 24402 as a whole is void and taxpayers may no longer claim the benefits or suffer the detriments of the deduction.[13] Indeed, informal sources at the FTB have indicated that the FTB already has begun to issue deficiency notices based upon the reversal of deductions taken under the DRD for tax years 1999 and thereafter.

In the face of this undertaking, it seems likely that taxpayers will challenge the legality of the FTB's action in litigation. There are a number of potential arguments for doing so:

First, taxpayers may argue that the FTB's enforcement actions to collect additional taxes from taxpayers who obtained an advantage of the discrim-

continued as "Farmers" on page 14

An Overview Of This Year's State Tax Programs

The State and Local Tax Group held its Annual State Tax Programs in California and New York to standing-room-only crowds during February and March 2004. Over breakfast, members of the State and Local Tax Group presented the practical implications of the latest legislative, judicial, and administrative developments affecting state and local tax across the country.

This year's programs addressed the following topics:

- Paul H. Frankel's annual "State of the States" address, which provided an informative and entertaining summary of the past year's major developments.
- "Legislation Affecting Related Party Transactions — Including California Tax Shelters," which provided an overview of numerous states' legislative responses to perceived corporate tax planning abuses. *Thomas H. Steele, Craig B. Fields, Andres Vallejo, and William H. Weissman presented in San Francisco; Thomas H. Steele, Hollis L. Hyans, and Craig B. Fields presented in New York.*
- "State Attacks on Related-Party Transactions," which discussed the past year's cases involving nexus attacks, the denial of deductions, and forced combination. *Thomas H. Steele, Hollis L. Hyans, Irwin M. Slomka, and Roberta Moseley Nero presented in New York.*
- "California State and Local Tax Developments," which addressed recent cases and administrative decisions, as well as recent and proposed legislation, that relate to California's corporate franchise, property, and sales and use taxes. *Charles J. Moll III, Eric J. Coffill, Pilar M. Sansone, and Troy M. Van Dongen presented in San Francisco.*
- "Other National Developments of Interest," which fielded audience questions regarding the Streamlined Sales Tax Project, recent cases and administrative decisions, recent and proposed legislation, and other national issues of note. *Thomas H. Steele, Craig B. Fields, and Andres Vallejo presented in San Francisco; Thomas H. Steele, Craig B. Fields, Irwin M. Slomka, and Michael A. Pearl presented in New York.*
- "Tax Court Proposals," which provided a summary of the Model State Administrative Tax Court Act, drafted by Craig B. Fields and the Administrative Court Task Force of the Committee on State and Local Taxation of the Taxation Section of the American Bar Association, which he chairs, and California's need for an independent tax tribunal. *Charles J. Moll III and Craig B. Fields presented in San Francisco; Craig B. Fields presented in New York.*

Please feel free to contact any member of our State and Local Tax Group regarding these and other state and local tax topics. ■

inatory DRD do not actually level the playing field as required by *McKesson.* Those arguments may be based upon one of two themes: (1) that the collection of a tax, years after the discrimination occurred, does not undo the competitive advantages enjoyed by taxpayers who paid a lower tax in past years; and (2) that the FTB's audit and collection procedures are not sufficiently robust to constitute the type

So viewed, California's "tax policy" of eliminating double taxation of corporate income creates discrimination against interstate commerce

of effort contemplated by *McKesson. See McKesson Corp., supra,* 496 U.S. at 41. This latter theme, particularly, may hold greater weight for 1999 because the FTB had little time following the U.S. Supreme Court's denial of the Cert. Petition to begin a widespread effort to collect additional taxes from the favored class that benefited from the DRD.

Second, taxpayers may argue that the Court of Appeal's decision in *Farmer Bros.* applies only to the offending restriction on the DRD. By excising the unconstitutional restriction on the limits of the deduction, the statute continues to operate in a manner consistent with legislative intent in eliminating multiple taxation of corporate earnings. *See* Cal. Rev. & Tax. Code § 23057 (California's severability clause applicable here); *see also Kopp v. Fair Political Practices Comm'n*, 11 Cal. 4th 607, 660-61 (1995) (recognizing a court's authority to reform statutes in accord with legislative intent if the legislature would have preferred reformation as opposed to the statute being found unconstitutional as a whole).[14]

Third, the Court of Appeal's reliance upon the internal consistency doctrine in its Commerce Clause analysis may be viewed as evidence that the offense of the current DRD is that it effectively seeks to tax income earned in other states. *See Hunt-Wesson, Inc. v. Franchise Tax Bd.,* 528 U.S. 458 (2000) (disallowance of an otherwise allowable deduction based upon the amount of out-of-state income is effectively an extraterritorial tax on the out-of-state income). This infirmity was also acknowledged by the trial court in its opinion in *Farmer Bros. See Farmer Bros. Co. v. Franchise Tax Bd.*, Case No. BC269404 (Superior Court of California, County of Los Angeles, Mar. 18, 2002). Because the source of the infirmity is taxing income beyond California's jurisdiction to tax, taxpayers may argue that the proper remedy is simply to extend the deduction and eliminate the unconstitutional tax.

Fourth, taxpayers may argue that a disallowance of the DRD provided by section 24402 also may be viewed as violating the Equal Protection Clause of the U.S. and California Constitutions since dividends paid by legal entities included within a combined report of unitary income will continue to enjoy a full dividend elimination under section 25106 even though no rational basis exists for distinguishing between the multiple tax burden that arises in that context and the multiple tax that would be imposed by a repeal of section 24402. *See generally Safeway Stores, Inc. v. Franchise Tax Bd.,* 3 Cal. 3d 745 (1970) (dividends not deductible despite inclusion of payor in the same combined report with the recipient because inclusion of the payor's income, in and of itself, does not result in California taxation of that income).

Finally, taxpayers may launch such challenges on the grounds that the continued existence of the DRD undoubtedly reflects the sound economic policy that corporate earnings should not be subject to multiple taxation. Indeed, as the FTB itself noted in its Cert. Petition, California has embodied this tax policy against multiple taxation (at least of its own making) since the outset of the corporate income tax.[15] Even in these times of budget shortfalls, it is difficult to imagine anyone making a principled argument that corporate earnings should be subject to multiple taxes as they make their way up the corporate chain.

Possible Legislation

Regardless of the results of such potential challenges, it appears likely that the California Legislature will ultimately be called upon to determine the fate of the DRD. In predicting what legislative action might occur, it is useful to examine the efforts that have occurred over the last few years to amend the insurance DRD, which the Court of Appeal struck down as discriminatory in *Ceridian*. In that effort, interested taxpayers have faced tough demands from the FTB and Legislature that any legislative fix also address unrelated perceived tax loopholes enjoyed by the insurance industry, perhaps in part to pay for the cost of a DRD refund. Recently, the FTB also has proposed that the deduction mechanism of the DRD be replaced with a credit mechanism whereby California taxes would be reduced only to the extent of other state taxes actually imposed upon the underlying earnings. While such a system has the advantage (from the State's viewpoint) of tailoring the elimination of multiple taxation to the amount of actual taxes imposed (at a minimum lowering the cost because most states have a lower tax rate than California), it also introduces considerable complexity in matching the dividends to the taxes actually imposed, particularly where states rely upon a different basis for tax (*e.g.*, gross receipts).

> *"The FTB already has begun to issue deficiency notices based upon the reversal of deductions taken under the DRD for tax years 1999 and thereafter*

Conclusion

While the conclusion of Farmer Bros.' challenge to California's DRD may have been predictable, the twists and turns of the litigation provided new insight into the tests for determining when a tax constitutes facial discrimination against interstate commerce, and particularly when the compensatory tax defense may be applied to save an otherwise discriminatory tax. The decision now leaves in its wake questions regarding the proper remedy for the unconstitutional limitations of the DRD, including whether a nondiscriminatory DRD will continue to provide relief from multiple taxation of corporate income. As the courts and the Legislature review this issue in the midst of California's budget crisis, hopefully they will keep in view the broader economic policy concerns. ■

[Mr. Steele was Counsel of Record to *Farmer Bros*. in the Supreme Court proceeding. Mr. Vallejo served as co-counsel in that proceeding.]

---

[1] This article was originally published in the *BNA Tax Management Weekly State Tax Report and Multistate Tax Report*. It is reprinted with permission from Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc., 1250 23rd Street, N.W., Washington, D.C. 20037 (www.bnatax.com).

[2] In terms of its impact upon State revenues, it appears that the *Farmer Bros.* litigation was one of the most expensive tax cases in the state's history. In published reports following the U.S. Supreme Court's denial of the Cert. Petition, spokespersons for the state estimated the revenue loss associated with the case as high as $1.5 billion plus an ongoing annual loss of $180 million. *See, e.g.,* David R. Doerr, "U.S. Supreme Court Lets Farmer Bros. Dividend Tax Decision Stand; FTB Likely to Treat it Like Ceridian," *Caltaxletter*, Vol. XVII, No. 8 (Ronald W. Roach ed., Feb. 27, 2004).

[3] In summary, the Court of Appeal found that the FTB had failed all three prongs of the compensatory tax defense because (a) the state's identification of its general income tax did not satisfy the requirement that the state identify a cognizable burden that intrastate commerce, but not interstate commerce, had been forced to pay; (b) having failed to identify such a burden, the state could not even begin to show that the intrastate burden was equal or greater than the burden on interstate commerce; and (c) because the income taxes in question were imposed upon different taxpayers, the state had not met its burden of showing the compensating tax was imposed upon a substantially equivalent event to that which triggered the facially discriminatory tax. *See Farmer Bros. Co.,* 108 Cal. App. 4th at 989-992.

[4] The FTB also filed a petition for certiorari with the California Supreme Court, which was denied.

[5] While the deduction provided under Internal Revenue Code section 243(a) is limited to dividends paid "from a domestic corporation which is subject to taxation under this chapter," the federal government has adopted a tax credit mechanism for eliminating multiple corporate taxation of dividends paid from foreign corporations. *See* I.R.C. §§ 901, 902. Moreover, because the federal government is not subject to the Commerce Clause, *see generally Kraft Gen. Foods, Inc. v. Iowa Dep't of Revenue & Fin.*, 505 U.S. 71 (1992), the limitation on the scope of the deduction provided by IRC section 243 provides no support for an "analogous" state limitation. Cert. Petition at 7-9.

[6] Cert. Petition at 9-10.

[7] Cert. Petition at 23.

[8] The FTB also sought to attract the U.S. Supreme Court's attention with another question: namely whether the compensatory tax defense is even applicable where the same tax (*i.e.,* in this case, the state income tax) constitutes both the facially discriminatory tax and the allegedly compensatory tax. (The FTB, of course, maintained that the defense should be applicable.) Because the answer to the question was not even in dispute in the litigation, we do not address it further here. Indeed, we certainly know of no reason that the compensatory tax defense could not be invoked when a single levy is involved in different contexts, particularly since the availability of the defense to sales and use tax appears to be premised upon the close alignment of the two taxes involved, an alignment that would be even closer where both the compensatory tax and the purportedly facially discriminatory tax are, in fact, the same tax levy.

[9] *D.D.I., Inc. v. North Dakota*, 657 N.W.2d 228 (N.D. 2003), was decided by the North Dakota Supreme Court. *Ceridian* was decided by another district of the same California Court of Appeal that issued the *Farmer Bros.* decision.

[10] Under current U.S. Supreme Court Commerce Clause decisions, the analysis of the effects of the DRD upon interstate commerce is probably best grounded by assuming that other states impose a tax regime identical to California's. *See D.D.I., Inc., supra,* 657 N.W.2d at 234 (noting that the Commerce Clause's internal consistency analysis requires an assumption of an identical tax in every state rather than proof that other states actually impose a similar tax burden). Nonetheless, a "real world" review would have produced the same conclusion since 46 states and the District of Columbia currently impose a tax on corporate income. I Hellerstein, *State Taxation: Corporate Income and Franchise Taxes* (2nd Ed. 1993), ¶1.02 at 1.8.

[11] Indeed, had California crafted its relief from double taxation in the form of a statutory credit (to be claimed by the recipient) against taxes imposed upon the payor of the dividend, there would appear to be little controversy that the Commerce Clause would require extension of any such credit to taxes paid to other states. For example, in discussing the workings of the compensatory tax defense in the context of a sales and use tax, the U.S. Supreme Court has stated:

> [I]n upholding tax schemes providing credits for taxes paid in state and occasioned by the same transaction, we have often pointed to concomitant credit provisions for taxes paid out of state as supporting our conclusion that a particular tax passed muster because it treated out-of-state and in-state taxpayers alike. *See*, *e.g., Itel Containers Int'l Corp. v. Huddleston,* 507 U.S. 60, 74 (1993); *D.H. Holmes Co. v. McNamara,* 486 U.S. 24, 31 (1988) ("The … taxing scheme is fairly apportioned, for it provides a credit against its use tax for sales taxes that have been paid in other States"); *General Trading Co. v. State Tax Comm'n of Iowa,* 322 U.S. 335 (1944); *Silas Mason, supra* at 584. A general requirement of equal treatment is thus amply clear from our precedent.

Okla. Tax Comm'n v. Jefferson Lines, Inc., 514 U.S. 175, 192 (1995). While the Court concludes this discussion with the caveat that it was expressing no opinion on "the need for equal treatment when a credit is allowed for payment of in-state or out-of-state taxes by a third party," *id.* (citing *Darnell v. Indiana,* 226 U.S. 390 (1912)), less than a year later, the Court resolved any ambiguity this limitation might have created by holding that *Darnell* was "no longer good law under the Commerce Clause." *Fulton, supra,* 516 U.S. at 346. *See also id.* at 348 ("*Darnell* simply cannot be reconciled with the compensatory-tax decisions cited in the Court's opinion …" (Chief Justice Rehnquist concurring)).

[12] Presumably, the DRD in this case would be limited to $91.16 and thus (depending upon the source of the additional $8.84 dividend) the investor could be exposed to tax of approximately $0.74 on the $100 dividend. Thus, the favored investor in a California company would have a net after-tax dividend of $99.26, as compared to the investor in an out-of-state company, which would have a net after-tax dividend of $91.16.

[13] *Cf.* Memorandum from Winston Mah and Dale Isaac, FTB, to General Tax Audit Staff and Multistate Tax Audit Staff (Apr. 26, 2002) (on file with author) (instructing the FTB Audit Staff that no deduction under section 24410 is to be allowed for tax years ending on or after Dec. 1, 1997).

[14] The *Ceridian* court refused to reform section 24410 because the formula used to calculate the deduction required broad substantive changes to operate constitutionally. Given the level of reform required, the Court of Appeal found that rewriting section 24410 would be an "encroachment on the legislative function in violation of the separation of powers doctrine." *Ceridian Corp.*, 85 Cal. App. 4th at 889. By contrast, it appears that section 24402 will operate constitutionally if only the offending subsection is stricken. For this reason, section 24402 may be more amenable to reform than section 24410.

[15] Cert. Petition at 9 (citing *Safeway Stores, Inc.,* 3 Cal. 3d at 750).

Maryland Tax Court Holds Lease Termination Payment Not Subject To Sales Tax

By Michael A. Pearl

The Maryland Tax Court recently held that lease termination payments for computer equipment are not subject to the state's sales tax because they are not "sales." In so holding, the Tax Court rejected the Comptroller's assertion that a lease termination payment was a payment of the taxable price paid. *See Citicorp Int'l Communications, Inc. v. Comptroller*, No. 02-SU-OO-0068 (Md. T.C. Feb. 23, 2004).

In the mid-1990s Citicorp International Communications, Inc. ("CICI"), a subsidiary of Citicorp, leased computer and related equipment from IBM Credit Corporation ("IBM") for use in its Maryland data center. Subsequently, CICI notified IBM that it wished to negotiate an early termination of the lease. The parties executed a lease termination agreement, pursuant to which IBM agreed to relieve CICI of its remaining obligations under the lease in consideration for a lump-sum payment of approximately 90 percent of the remaining lease payments and the return of the leased equipment.

CICI paid Maryland sales tax on its lease termination payment and requested a refund, which the Comptroller denied.

CICI appealed the Comptroller's denial to the Maryland Tax Court. The Comptroller argued that because the Petitioner had an "absolute and unconditional" obligation under the lease to make rental payments, the lump-sum payment was "part and parcel" of the lease and merely an acceleration of the rental payments due thereunder. The Comptroller reasoned that the payment is taxable "consideration of any kind required to be paid to the lessor under the terms of the lease," in accordance with the Comptroller's regulations. *See* Md. Regs. Code 03.06.01.28E(1).

CICI argued that the Comptroller's position was contrary both to the terms of the lease, which allowed for "modification" or "termination" by written consent of the parties, and to the doctrine of "freedom of contract," which is incorporated in Maryland Commercial Law. *See* Official Comment to Md. Code Ann., Com. Law § 2A-101 ("The common law of leasing is dominated by the need to preserve freedom of contract."). Furthermore, CICI argued that the lump-sum payment was made pursuant to a separate lease termination agreement and not pursuant to the lease itself. Accordingly, the lease termination transaction was not a "sale" as defined by Md. Code Ann., section 11-101(g)(1), because the payment was not consideration for the transfer of title or possession of property, but rather, was consideration for the relinquishment of the right to possess or use property.

The Tax Court found that the termination agreement "is a separate and distinct agreement from, and not an amendment to," the lease. Further, the Tax Court agreed with CICI's interpretation of the lease and the sales tax statute and concluded that "[t]he clear and unambiguous provisions of the [lease and the lease termination agreement] and the lack of any transfer of title of the leased property to the Petitioner establish that the lease termination payment was not made pursuant to a transaction that is a 'sale' as defined by §11-101(g)."

Notwithstanding the Tax Court's well-reasoned decision, the Comptroller has filed an appeal in the Circuit Court for Baltimore City. ■

[Michael A. Pearl served as lead counsel for Citicorp International Communications, Inc. in this matter.]

Toys, continued from page 9

As part of the restructuring, Toys "R" Us also formed a corporation to provide real estate mortgage financing to the Toys "R" Us retail companies, and formed another corporation that principally made intercompany loans to those companies ("the financing companies").

"[T]he ALJ held that the evidence established that the intercompany transactions between them — particularly the royalty payments made to Geoffrey — were at arm's length

Toys-NYTEX filed its own separate New York City GCT returns. The New York City Department of Finance ("New York City") claimed that Toys-NYTEX must file its returns on a combined basis with Geoffrey, as well as with the financing companies.

The Parties' Positions

New York City took the position that the combination of Toys-NYTEX and Geoffrey was required because the 1984 transfer of the intangibles, coupled with the license of these intangibles from Geoffrey, lacked economic substance, and that Toys-NYTEX's income was not properly reflected without including Geoffrey in its tax return. In effect, New York City argued that there was distortion — the third requirement for combination — because Geoffrey was not entitled to *any* royalty payments.

Toys-NYTEX maintained that the initial transfers of the Marks — made several years prior to the years in controversy — were valid transactions for both tax and business purposes and that the royalty payments were made at arm's length. At the administrative hearing, Toys-NYTEX presented extensive evidence — from two independent economists — that the royalty payments were at arm's length rates under IRC section 482. No evidence was introduced by New York City to rebut the proof of arm's-length pricing.

ALJ Determination. In 1999, a New York City Administrative Law Judge ("ALJ") held that Toys-NYTEX was *not* required to file on a combined basis with Geoffrey or the financing companies. Although the presence of "substantial intercorporate transactions" between Toys-NYTEX and Geoffrey, and between Toys-NYTEX and the financing companies, created a *rebuttable* presumption of distortion, the ALJ held that the evidence established that the intercompany transactions between them — particularly the royalty payments made to Geoffrey — were at arm's length. Thus, the company had successfully rebutted the "presumption of distortion." The ALJ found that the formation of Geoffrey and the licensing of the Marks were bona fide transactions having economic substance and genuine business purpose and was not entered into solely for tax avoidance purposes. The ALJ also found that Toys "R" Us had made a valid transfer of the Marks, along with the associated goodwill. The fact that there were also acknowledged state tax benefits could not, the ALJ held, cause the transactions to be disregarded.

NYC Appeal

New York City appealed the determination to the New York City Tribunal, raising the same arguments as it did before, and challenging more than half of the ALJ's 80 findings of fact. While the City Tribunal was deliberating, a potential complication arose when the New York State Tax Appeals Tribunal ("State Tribunal") issued its decision in the matter of *Sherwin-Williams Companies*, DTA No. 816712 (N.Y.S. Tax App. Trib., June 5, 2003), a case involving issues similar to those in *Toys "R" Us-NYTEX*. Reversing a 150-page ALJ determination, the State Tribunal, in *Sherwin-Williams*, held that New York State properly combined The Sherwin-Williams Company with its two intangibles holding companies. The State Tribunal found that Sherwin-Williams had failed to rebut the presumption of distortion. Moreover, it held that the licensing arrangement lacked a valid business purpose. (The *Sherwin-Williams* decision is currently on appeal.) Since the City Tribunal is required to follow the prior precedential decisions of the State Tribunal, the City Tribunal also had to consider the impact of *Sherwin-Williams*.

City Tribunal Decision

In *Toys "R" Us-NYTEX*, the City Tribunal upheld the ALJ's determination that combination was not required, but on somewhat different grounds. The City Tribunal held that under the City's own rules and the New York case law on combination, whether or not distortion exists depends on whether the taxpayer is able to rebut the presumption of distortion arising from substantial intercorporate transactions. Here, Toys-NYTEX had introduced evidence regarding the arm's length nature of the intercompany pricing, and New York City had not introduced any evidence to the contrary. Therefore, the City Tribunal held that Toys "R" Us had successfully rebutted the presumption of distortion and should not be combined. The City Tribunal also rejected the relevance of the business purpose and economic substance analysis in determining whether combination is appropriate. New York City may not appeal this decision, and it is now final. *See* N.Y.C. Charter § 171.

Reconciling *Toys "R" Us-NYTEX* with *Sherwin-Williams*

Reading the *Toys "R" Us-NYTEX* decision (which is final) together with the *Sherwin-Williams* decision (which is on appeal to the New York courts) necessarily raises the question whether the two decisions can be reconciled. In the City Tribunal's view, the answer is clearly, "Yes." According to the City Tribunal: "It is important to note that the State Tribunal [in *Sherwin-Williams*] did not rest their decision on the basis of their conclusion that the transfer of the Marks and license-back had neither economic substance nor a valid business purpose. The State Tribunal undertook an analysis of whether the charges at issue were arm's length before deciding that the taxpayer had not met its burden of overcoming the presumption of distortion, and that combination was appropriate." Put another way, if the State Tribunal in *Sherwin-Williams* truly believed that its conclusions about the alleged lack of business purpose was determinative, there was no need to address the arm's length pricing issue as it did. Thus, it seems reasonable to view the City Tribunal and State Tribunal as having applied the same analysis, but as having reached different conclusions because, in *Toys "R" Us-NYTEX*, New York City failed to rebut the pricing evidence, while in *Sherwin-Williams*, the State Tribunal found that New York State did rebut the pricing evidence.

A different view is that the two Tribunals have now gone in different directions on issues of combination, and that the State Tribunal (unlike the City Tribunal) will uphold forced combination where New York State perceives that an intercompany transaction lacks a business purpose. One problem with this view is that if a "sham transaction" is found to exist, the more appropriate remedy would

> *"The City Tribunal also rejected the relevance of the business purpose and economic substance analysis in determining whether combination is appropriate*

be to either disregard the deduction resulting from the transaction or to disregard the intangible holding company itself as a "sham."

The Future

What will New York City do in light of the taxpayer victory in *Toys "R" Us-NYTEX*? The City Tribunal has clearly held that arm's length pricing is the critical factor in rebutting the presumption of distortion. Early indications from the City are that it may delay meaningful resolution of intangibles holding company combination disputes pending the eventual outcome of *Sherwin-Williams*. Yet, it is questionable that the City Tribunal would have ruled any differently if a *court* had rendered the *Sherwin-Williams* decision, rather than the State Tribunal.

Since most intercompany royalties must be added back under recent New York legislation for tax years beginning on or after January 1, 2003, some may view the *Toys "R" Us-NYTEX* decision as being of limited importance. This would be a mistake. While the New York royalty addback legislation may have addressed the narrow issue of royalties, there is little doubt that there will be other instances in which New York City and New York State attempt to address other perceived distortions from intercompany transactions that allegedly lack a business purpose. The *Toys "R" Us-NYTEX* decision makes clear, as no New York decision has before, that arm's length pricing will determine the outcome of those other combination cases as well. ■

[Paul H. Frankel, Hollis L. Hyans, and Irwin M. Slomka served as co-counsel for Toys "R" Us-NYTEX, Inc. in this matter.]

Tax Court in *Schwab* Rules on Timing of Federal Deduction for California Franchise Tax

Eric J. Coffill (ecoffill@mofo.com)

In *The Charles Schwab Corporation and Subsidiaries v. Commissioner,* 122 T.C. No. 10, 2004 U.S. Tax Ct. LEXIS 10 (Mar. 9, 2004) ("*Schwab II*"), the Tax Court held the taxpayer was not entitled to accelerate into 1990-1992 California franchise tax deductions originally claimed for 1991-1993 for federal tax reporting purposes. The case discusses the interplay of Internal Revenue Code ("IRC") section 461(d) and 1972 California Legislation regarding the accrual date for California franchise taxes, and is a follow-up to an earlier Tax Court decision in *Charles Schwab Corp. & Includible Subs. v. Commissioner,* 107 T.C. 282 (1996) (*Schwab I*).

In *Schwab I,* the taxpayer had argued that a California franchise tax deduction it originally deducted on its 1989 calendar year federal return was deductible for its short year ended December 31, 1988. (The short year return was the result of the taxpayer changing its tax year for federal income tax purposes, from a March 31 fiscal year to a December 31 calendar year during 1988, so that its calendar year return ending December 31, 1988 was a short year consisting of nine months.) The Tax Court agreed. However, the decision in *Schwab I* left the taxpayer unable to take a deduction for California franchise tax on its 1989 calendar year federal return.

In *Schwab II*, the taxpayer then argued it was entitled to deduct California franchise tax liabilities for the same taxable period for which the franchise tax was calculated, *i.e.*, the year prior to the year for which the taxpayer originally deducted the California franchise tax on its federal tax returns. In other words, the taxpayer argued franchise tax deductions originally claimed on its 1990 calendar year federal return now should be deductible on its 1989 calendar year federal return.

As explained by the Tax Court, the issue in the case arose in connection with the parties' disagreement concerning the application and interpretation of IRC section 461(d), and section 1.461-1(d)(1) of the Income Tax Regulations. IRC section 461(d) was enacted to proscribe the acceleration of state and local tax deductions due to state or local legislation enacted after 1960. IRC section 164(a) generally provides for the deduction of qualified state and local taxes in the year paid or accrued, and the California franchise tax is a type of tax that would normally be deductible under IRC section 164(a). However, the application of IRC section 164(a) was modified during 1960 by the enactment of IRC section 461(d), which proscribes the accrual of state tax attributable to post-1960 state legislation that would accelerate the accrual of such tax.

The Tax Court explained the operation of IRC section 461(d) is illustrated by section 1.461-1(d)(3), Example (1). In that example, the tax assessment (and therefore accrual) date was July 1 each year, and in 1961 California changed the law to move the assessment date from July 1, 1962 to December 31, 1961. But for IRC section 461(d), taxpayers, under the accrual method of accounting, would have been entitled to accrue and deduct, for the federal tax year 1962, the state tax assessed on both July 1, 1962 (for the 1961 California tax year) *and* December 31, 1962 (for the 1962 California tax year), because of the change in the law.

The California franchise tax is imposed on every corporation doing business in California for the privilege of exercising its corporate franchise in California. *See* Cal. Rev. & Tax. Code § 23151(a). Federal case law had held that although the pre-1972 California franchise tax was measured by the preceding year's net income, it did not accrue until the taxable (or next year). The Tax Court found a 1972 amendment to the California statute changed the accrual date for all California franchise taxpayers from January 1 of the taxable year to December 31 of the income year (preceding year).

The Tax Court concluded the effect of the 1972 California amendment was to accelerate the accrual of franchise tax to an earlier tax year, and found that IRC section 461(d) expressly addresses the type of legislation enacted by California in the form of the 1972 amendments to its franchise tax law. Accordingly, the 1972 California amendment could not be used to accelerate the accrual of California franchise tax. (But for IRC section 461(d), the court pointed out, a corporation would be entitled to two franchise tax accruals in the first effective year of the 1972 amendments.) The Tax Court commented the taxpayer's "idiosyncratic circumstances" occurred because of the convergence of its 1987 short year and the December 31, 1988 accrual of its 1988 short federal tax return, and the result in *Schwab I.* However, the Tax Court concluded those unique circumstances did not support different treatment for the taxpayer than would be afforded to other California corporate franchise taxpayers for the taxable years following taxpayer's unique initial circumstances for 1987–1989. The Tax Court acknowledged the "anomalous result," *i.e.*, that no California franchise tax deduction is allowable for 1989, but showed little sympathy by concluding there is nothing in IRC section 461(d) that suggests "that a taxpayer is guaranteed a tax accrual in every taxable year."

While the convergence of the unusual facts in the case and the result in *Schwab I* makes *Schwab II* a decision that should have little affect upon the typical corporate federal taxpayer attempting to deduct California franchise tax, the Tax Court's conclusion that a taxpayer is not guaranteed a tax accrual in every taxable year may have some application to other situations. Accordingly, the decision is of interest, in view of the rarity of federal tax cases that address the deductibility of California franchise taxes. ■

MoFo SALT Attorney News

Congratulations

The attorneys and staff at Morrison & Foerster congratulate our esteemed colleague **Charles ("Chuck") J. Moll, III** on his appointment to Chair of the Tax Section of the California Bar. Chuck, a partner in the firm's San Francisco office, is once again recognized for his excellence and hard work by his California colleagues. We wish Chuck and the Tax Section of the California Bar much success with the important topics on this year's agenda — particularly the proposed California Tax Court legislation!

Andres Vallejo has been appointed Chair, and **Pilar M. Sansone** has been appointed Vice Chair, of the Taxation Section of the San Francisco Bar Association's Barristers Club.

During their tenure, the Taxation Section will begin holding a series of bimonthly breakfast meetings designed to provide a forum for discussing current developments in state and local tax law, as well as an opportunity for the Bay Area's state and local tax community to meet on a regular basis. *See sidebar on page 6 for more information*.

Welcome

Morrison & Foerster's State and Local Tax Group would like to welcome four new attorneys to its practice. **Mitchell A. Newmark**, **David A. Agosto**, and **R. Gregory Roberts** have joined the firm's New York office, and **William H. Weissman** has joined the firm's San Francisco office.

Mitchell joined the group as of counsel. Mitchell will focus on state and local tax litigation and planning. Prior to joining Morrison & Foerster, he was a Deputy Attorney General in the New Jersey Attorney General's Office, where he defended and counseled the Division of Taxation in Corporation Business Tax and Gross Income Tax matters, and the Commissioner of Banking and Insurance in complex financial services company conversions. Mitchell is a graduate of Widener University School of Law, *cum laude*, where he was a board member of the law review, the *Delaware Journal of Corporate Law*. He also has an LL.M. in Taxation from Georgetown University Law Center, and an M.B.A. from Rutgers University Graduate School of Management.

David also will be joining the group as of counsel. David has extensive experience counseling corporate and individual taxpayers in all aspects of state and local tax, particularly income, franchise, sales and use, and excise taxes. He has represented taxpayers at formal and informal administrative hearings and court proceedings in over 25 jurisdictions throughout the United States, and counseled clients in planning opportunities for transactions to minimize exposure to state and local taxes. David received his B.A. from Yale University, his J.D. from Columbia University, and his LL.M. in Taxation from New York University.

Gregg has joined the group as an associate. He has experience in corporate income, franchise, and property taxes, and has represented clients in their appeals before administrative tribunals and courts in numerous states. Gregg has also been involved in planning and corporate restructuring matters. Gregg received his B.A., *summa cum laude*, from the University of Rochester in 1996 and his J.D., *magna cum laude*, from The American University, Washington College of Law in 1999.

William joined the firm as an attorney. He served as tax counsel in the California Franchise Tax Board's Multistate Tax Bureau since 1999, where he gained extensive experience in numerous aspects of multistate taxation, including unity, business/nonbusiness income, apportionment factors, and water's-edge issues. William has authored several articles in *State Tax Notes*, and received his J.D. degree, *cum laude*, from the District of Columbia School of Law and an LL.M. in Taxation from Golden Gate University School of Law. ■

Morrison & Foerster's State and Local Tax Group

The Morrison & Foerster State and Local Tax Group is nationally recognized for its practice in the area of state and local taxation. Our group is composed of 22 lawyers who are involved in all aspects of planning and consulting with respect to state and local tax issues, representation in administrative controversies before state and local tax agencies, and litigation. Because of the experience of the group's lawyers in many different jurisdictions, the group is able to approach state and local tax problems from a nationwide perspective, taking into account the similarities and differences of state and local tax systems throughout the United States.

Our tax lawyers have handled many of the most important cases affecting state and local taxation, including a number that involved the U.S. Supreme Court. For example, the group recently represented Farmer Bros. Co. in its successful challenge to California's discriminatory dividend received deduction, which was recently concluded when the U.S. Supreme Court denied California's cert. petition, Hunt-Wesson in its successful challenge to California's franchise tax interest offset provision, and Allied-Signal Inc., in its successful challenge to New Jersey's imposition of tax on intangible income earned by a non-domiciliary corporation from an investment in a non-unitary corporation. The group represented both Colgate-Palmolive Company and Container Corporation in their Supreme Court challenges to the California worldwide unitary method of taxation. In addition, the group represented McKesson Corporation before the U.S. Supreme Court in McKesson's successful challenge to Florida's refusal to refund taxes previously exacted under an unconstitutional statute. We also have successfully represented taxpayers in litigation before the U.S. Supreme Court contesting the application of sales taxes to national banks and several other state tax matters.

Our group focuses on the particular challenges of presenting state tax issues to courts of general jurisdiction, which often require significant background education to deal with sophisticated tax issues. In this regard, our lawyers have successfully appeared in high profile cases in a number of states, including on behalf of Sherwin Williams in its successful appeal before the Massachusetts Supreme Judicial Court, Panhandle Eastern in its successful appeal to the Kansas Supreme Court, GTE in its successful appeal before the Kentucky Supreme Court, and Hercules before the Supreme Courts of both Minnesota and Maryland.

Our group's familiarity with tax systems across the United States has aided clients in efficiently resolving or contesting issues raised on audit simultaneously in more than one state. Our group has handled state administrative proceedings in virtually every state and currently has matters pending in more than half of the states.

In addition to our controversy work, our attorneys regularly assist clients in state and local tax planning and in structuring transactions. These efforts include multistate analyses in the context of mergers, acquisitions, and dispositions, as well as in connection with reorganizing current operations. These clients range in size from over one-half of the Fortune 100 listing of America's largest corporations to individuals involved in state tax disputes.

The range of state and local taxes with respect to which the group has represented and given counsel to its clients includes corporate franchise and income taxes, sales and use taxes, real and personal property taxes, local business license taxes, gross receipts taxes, telecommunications taxes, severance taxes, capital stock taxes, documentary and other transfer taxes, and personal income taxes. Planning projects frequently involve simultaneous consideration of many or all of these taxes. ■

This newsletter addresses recent state and local tax developments. Because of its generality, the information provided herein may not be applicable in all situations and should not be acted upon without specific legal advice based on particlar situations.

If you wish to change an address, add a subscriber, or comment on this newsletter, please write to Mitchell A. Newmark and Pilar M. Sansone at Morrison & Foerster LLP, 425 Market Street, San Francisco, California 94105-2482, or e-mail them at *mnewmark@mofo.com* and *psansone@mofo.com.*