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State & Local Tax Insights

Mitchell A. Newmark & Pilar M. Sansone, Co-Editors *Winter 2007*

Inside

3
Upcoming Conferences

5
California's LLC Tax: Current Litigation and Retroactive Legislation
By Peter B. Kanter and Jeffrey S. Terraciano

7
New California FTB Time Goals for Processing Protests
By Eric J. Coffill

13
Sales Factor Gross Receipts Cases Addressed by the California Supreme Court
By Carley A. Roberts

15
LLC Fee Refund Procedures

23
MoFo SALT Attorney News

ATTORNEY ADVERTISING

New Jersey Attempts an End Run Around P.L. 86-272 While Throwout and *Lanco* Are Challenged

By Craig B. Fields and Mitchell A. Newmark

New Jersey continues to take aggressive stances against foreign corporations. It asserts that physical presence is not necessary to subject a foreign corporation to income taxation in New Jersey. *See Lanco, Inc. v. Director, Division of Taxation,* 188 N.J. 380 (2006) (petition for certiorari pending) (holding that *Quill*'s physical presence test does not apply to income taxes under the Commerce Clause). It applies the alternative minimum assessment ("AMA") to foreign corporations that are protected from net income based taxes by federal law P.L. 86-272 only if those corporations do not consent to jurisdiction under New Jersey's regular Corporation Business Tax ("CBT"). It removes receipts from the denominator of the receipts fraction based on whether *another state* has jurisdiction to tax the corporation or whether *another state* has decided to exercise its right to tax the corporation, under what has become known as the "throwout" rule. Further, when New Jersey throws receipts out of the denominator, it contradicts its subjectivity position (its *Lanco* economic nexus position) because it applies economic nexus standards for subjectivity in New Jersey yet refuses to apply those same economic nexus standards for subjectivity in other states.

There is hope that New Jersey will be turned back. We are filing a petition for certiorari in the United

Continued on Page 2

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P.L. 86-272

Continued from Page 1

States Supreme Court in *Lanco*. The New Jersey Supreme Court favored the State's fisc and misapplied Commerce Clause case law under the United States Constitution. As Justice Benjamin's dissent stated in *MBNA*, economic nexus positions, like those asserted by the states in *MBNA* and in *Lanco*, rely

> not on bedrock constitutional principles or on established legal precedent, but rather on legal commentaries with thinly veiled state-favoring taxing agendas, a strained and inaccurate reading of the United States Supreme Court's decision in *Quill Corp. v. North Dakota*, 504 U.S. 298, 112 S. Ct. 1904, 111 L. Ed. 2d 91 (2002), and a unilateral restatement of the important policy considerations which led to the inclusion of the Commerce Clause within the United States Constitution . . . .

Tax Commissioner of W. Va. v. MBNA Am. Bank, N.A., Docket No. 33049 (W. Va. Nov. 21, 2006) (Benjamin, J., dissenting, slip op. at 1 (Jan. 2, 2007)). We hope that the United States Supreme Court will soon confirm that the physical presence standard exists for all taxes.

We are challenging the throwout rule on constitutional and statutory grounds in the Tax Court of New Jersey. Throwout violates *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274 (1977), because, as a result of throwout, the CBT is not fairly apportioned and discriminates against interstate commerce. Moreover, it violates New Jersey law.

Additionally, the application of the AMA to corporations that have P.L. 86-272 protection is, at best, questionable and should be struck down.

New Jersey is out on a limb on nexus, throwout, and the AMA. By these corporation tax policies, New Jersey is also contradicting its governor's expressly stated policy of becoming business-friendly.

NEW JERSEY'S BUSINESS ENVIRONMENT

Recently, New Jersey Governor Corzine "pledged to erase the perception that New Jersey was, in his words, 'adversarial' to business." David W. Chen, *Corzine Offers Proposals to Bolster Business Climate*, N.Y. Times, Sept. 8, 2006, at B1. Also, Dean Hughes and Professor Seneca, two prominent New Jersey economists at Rutgers University's Bloustein School of Planning & Public Policy, noted "a dramatic shift in the nation's high technology geography away from New Jersey." James W. Hughes & Joseph J. Seneca, *High-Tech Industry Leaving New Jersey*, Bergen Record, Sept. 17, 2006. Those economists note that the United States as a whole and California, Georgia, North Carolina, Texas, and Virginia, in particular, have gained high-tech jobs.

As part of Governor Corzine's pledge, he announced his strategy to "build an environment conducive to economic growth, innovation, and prosperity" in New Jersey and to remove the "negative perceptions of the state's business climate." Jon S. Corzine, *Economic Growth Strategy for the State of New Jersey 2007*, at 2, 5. The Governor's strategy assures that it will not require the State to raise new revenue. The Governor

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promised: "all resources for executing this strategy are redirected from other sources." *Id.* at 3. As discussed below, one of those other sources is multistate corporations.

Governor Corzine set forth a six-point plan for growing business and jobs in New Jersey. *Id.* at 3.[1] He said that "stabilizing [New Jersey's] business taxes is critical to attracting capital investment." *Id.* at 5. He credits his administration's progress in reducing business taxes by "the elimination of the alternative minimum assessments." *Id.* at 5. Dean Hughes and Professor Seneca highlight the Governor's progress but note that: "Continual examination of the state's business climate with additional changes [to the tax code] is warranted." Hughes & Seneca, *supra*. Additional examination is certainly warranted.

The subtext of the Governor's tax strategy (exporting the tax burden) is revealed upon closer scrutiny. The alternative minimum assessments are not eliminated for non-New Jersey corporations that are protected by P.L. 86-272. Thus, the only corporations that are subject to the AMA are those that are protected by federal law from the imposition of the net income component of the CBT (such corporations are still subject to the minimum tax under the CBT).

Continued on Page 4

Upcoming 2007 Conferences

Following is a list of SALT conferences through June 2007, in which Morrison & Foerster attorneys will be participating.

MARCH 29
Cleveland TEI Tax Conference
Cleveland, OH
Paul H. Frankel

APRIL 24
Dallas TEI Tax Conference
Dallas, TX
Paul H. Frankel

APRIL 25
Philadelphia TEI Tax Conference
Philadelphia, PA
Eric J. Coffill and Hollis L. Hyans

APRIL 26
Morrison & Foerster Annual "East Coast" Tax Seminar
New York, NY
Paul H. Frankel, Hollis L. Hyans, Craig B. Fields, Irwin M. Slomka, and Carley A. Roberts

MAY 1
New Mexico Tax Conference
Santa Fe, N.M.
Paul H. Frankel

MAY 3
COST School
Atlanta, GA
Paul H. Frankel

MAY 7
Energy Tax Association, 2007 Annual Meeting
San Antonio, TX
Craig B. Fields

MAY 8
Portland TEI Tax Conference
Portland, OR
Paul H. Frankel

MAY 16
Georgetown University Law Center, Advanced State and Local Tax Institute
Washington, D.C.
Craig B. Fields and Hollis L. Hyans

MAY 17
Morrison & Foerster Annual "West Coast" Tax Seminar
San Francisco, CA
Thomas H. Steele, Eric J. Coffill, Peter B. Kanter, Irwin M. Slomka, James P. Kratochvill, Andres Vallejo, Carley A. Roberts, and Pilar M. Sansone

MAY 18
Georgetown SALT Conference
Washington, D.C.
Paul H. Frankel

MAY 18
Los Angeles TEI Tax Conference
Los Angeles, CA
Thomas H. Steele, Eric J. Coffill, Peter B. Kanter, Andres Vallejo, Carley A. Roberts, and Pilar M. Sansone

MAY 21
COST Income Tax Conference
New Orleans, LA
Paul H. Frankel

MAY 23
Denver TEI Tax Conference
Denver, CO
Thomas H. Steele

MAY 30
Cincinnati IPT Tax Conference
Cincinnati, OH
Paul H. Frankel

JUNE 14
University of Wisconsin Tax Conference
Milwaukee, WI
Paul H. Frankel

OCTOBER 17-19
Paul J. Hartman SALT Forum (Vanderbilt University)
Nashville, TN
Paul H. Frankel, Hollis L. Hyans, and Craig B. Fields

P.L. 86-272

Continued from Page 3

NEW JERSEY'S CONTRADICTORY POSITIONS

Aside from inviting retaliation from other states to enact similar taxes, New Jersey has taken contradictory positions of interpretation. New Jersey argues on the one hand that its own laws should *not* be interpreted strictly but on the other hand argues that federal law should be interpreted strictly.

New Jersey is a separate-entity state, which means that each corporation that has sufficient contacts with New Jersey must file its own CBT return.[2] New Jersey interprets its separate-entity laws loosely by refusing to respect arm's-length transactions among affiliated corporations, notwithstanding that those corporations are separate corporations, and the rights of corporations that are not present in New Jersey to not be subject to New Jersey income tax. One example of a loose interpretation of New Jersey law is that New Jersey asserts nexus over companies whose only connection to New Jersey is the receipt of royalties from licensees that are located in New Jersey.[3] An example of New Jersey's strict interpretation of federal law is its interpretation of P.L. 86-272 and its assertion that the AMA and throwout laws do not violate P.L. 86-272.

One of the hottest issues in state and local taxation for the past half century is nexus, *i.e.*, does a corporation have sufficient contacts with a taxing state to allow that state to subject the corporation to tax. A corporation that solicits and delivers goods into a state with which it has no other contacts has constitutional nexus but is protected from the imposition of a net income tax upon it by federal law (*i.e.*, P.L. 86-272). P.L. 86-272 prohibits a taxing state from imposing a net income-based tax on a corporation's net income if that corporation's only activity with the taxing state is the solicitation and delivery of goods. Services are not protected by that federal law.

New Jersey has said…that it will get P.L. 86-272-protected corporations for protected activities in New Jersey and it will get P.L. 86-272-protected corporations for protected activities in other states.

Corporations have segregated manufacturing, finance, sales, intellectual property, and other businesses into separate corporations for various business reasons, including risk management, attraction of capital, and isolation of costs for comparison with other sourcing alternatives. By that segregation, businesses have been split into separately functioning corporations.

Separate-entity states, such as New Jersey, have cried foul over the establishment of these separate corporations and assert that the result of these separate corporations is an "end run" around their separate-entity tax-return filing laws. Separate-entity states have made the choice to be separate-entity states rather than unitary states. In *Lanco, Inc. v. Director, Division of Taxation,* 188 N.J. 380 (2006), and in other similar cases, New Jersey has asserted that corporations have executed an "end run" for nexus purposes. However, it is New Jersey itself that is attempting to execute an "end run" around P.L. 86-272.

Continued on Page 6

California's LLC Tax: Current Litigation and Retroactive Legislation

By Peter B. Kanter and Jeffrey S. Terraciano

Section 17942 of California's Revenue & Taxation Code[1] imposes an annual levy[2] on all limited liability companies ("LLC") registered to do business in the state. Currently, the levy is unapportioned, such that an LLC's liability for the fee is set by its total gross receipts worldwide, rather than its income attributable to business within California. The San Francisco Superior Court in *Northwest Energetic Services, LLC v. Franchise Tax Board*[3] ("*Northwest*") found the unapportioned levy unconstitutional, and awarded Northwest Energetic Services a full refund of the amounts it had paid under section 17942. While the superior court's decision in *Northwest* is legally binding only for the taxpayer that brought the suit, because California's Franchise Tax Board ("FTB") recently sought review of the trial court's decision, the case will likely determine the fate of section 17942 on appeal. Similarly, another case challenging the constitutionality of section 17942 under different facts, *Ventas Finance I, LLC v. Franchise Tax Board*[4] ("*Ventas*"), was recently decided by the San Francisco Superior Court. As in *Northwest*, the San Francisco Superior Court in *Ventas* ruled that section 17942 is unconstitutional because it is not apportioned.

In the wake of the *Northwest* decision, the California legislature proposed amendments to section 17942 in an attempt to remedy the unconstitutionality of the statute (A.B. 1614). The amended version of section 17942 would have continued to impose an annual levy on LLCs doing business in California; however, the amount owed would have been apportioned based on the amount of business that each taxpayer actually did within the state. Had the proposed amendments become law, they expressly would have applied retroactively as of 2001. Under the proposed amendments, some LLCs that paid the unapportioned levy in years 2001-2005 might have been entitled to a full refund. However, many would have received only a partial refund or no refund at all, depending upon the extent of the LLC's business activities in California. However, under the 2005 ruling by the California Court of Appeal in *City of Modesto v. National Med, Inc.*[5] ("*NMI*"), the retroactive apportionment provision in the proposed amendments may itself have been unconstitutional.[6]

> The San Francisco Superior Court…found the unapportioned levy unconstitutional, and awarded Northwest Energetic Services a full refund of the amounts it had paid under section 17942.

This article describes the challenges to section 17942 raised by the taxpayers in *Northwest* and *Ventas*, and discusses whether the legislature's proposed amendments to section 17942 would have been an adequate solution in light

Continued on Page 14

P.L. 86-272

Continued from Page 4

New Jersey enacted two laws that attempt an "end run" around P.L. 86-272. The AMA applies directly to corporations that are protected by P.L. 86-272 in New Jersey. The throwout law applies to corporations that have P.L. 86-272 protection in other states.

THE ALTERNATIVE MINIMUM ASSESSMENT

When the New Jersey Legislature enacted the Business Tax Reform Act of 2002 ("BTRA"), it created a special tax applicable to companies that are protected by P.L. 86-272 and that do not consent to jurisdiction under New Jersey's regular Corporation Business Tax. A company that is protected by P.L. 86-272 and does not consent to jurisdiction is subject to the AMA. N.J. Stat. Ann. 54:10A-5a(e).[4]

New Jersey interprets P.L. 86-272 strictly. However, it also argues that separate corporations should not interpret the separate-entity tax laws of New Jersey strictly. New Jersey plays both ends to its advantage. Contrary to Governor Corzine's strategy and remarks, it is not business-friendly. It is, in his words, "'adversarial' to business." Chen, *supra*.

New Jersey's application of the AMA to out-of-state protected corporations is unconstitutional discrimination and indirect apportionment where direct apportionment would not be permitted. *Fulton Corp. v. Faulkner*, 516 U.S. 325 (1996), prohibits a state from favoring domestic corporations over foreign corporations and discouraging interstate commerce. Corporations that are residents in New Jersey are subject to the net income computation of the CBT. Therefore, they are allowed to take their ordinary business expenses as deductions. Non-resident corporations that do not consent to New Jersey's imposition of the net income computation of the CBT (because they have the protection of P.L. 86-272) are subject to the AMA. Therefore, non-resident corporations are allowed no such deductions.

Hunt-Wesson, Inc. v. Franchise Tax Board of California, 528 U.S. 458 (2000), prohibits a state from doing indirectly what it cannot do directly. New Jersey is prohibited by P.L. 86-272 from subjecting protected corporations to a net income-based tax. New Jersey's application of the AMA to P.L. 86-272 is an indirect shot at taxing the protected activity and is an indirect "end run."

THROWOUT

Further in the BTRA, New Jersey created a special apportionment formula for corporations that are protected by P.L. 86-272 in other states. Ordinarily, the income of a corporation is apportioned (or as New Jersey describes it, "allocated") by a factor derived by the average of the sum of a property fraction, a payroll fraction, and a doubled sales fraction. A corporation that has income that is not taxed in a state, such as for reasons of P.L. 86-272 protection, apportions its income using the same four-factor formula; however, the sales that are assigned to any state's sales to which the protections of P.L. 86-272 apply are thrown out of the denominator of the sales fraction. N.J. Stat. Ann. 54:10A-6(B)(6). The throwout, in many situations, results in the apportionment to New Jersey of income that is out of all appropriate proportion to the corporation's activities in New Jersey and to the services provided by New Jersey. *Container Corp. of Am. v. Franchise Tax Bd.*, 463 U.S. 159 (1983); *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274 (1977). It is also wrong-headed for business.

If a corporation is organized under the laws of Ohio, has its home office in Ohio, has a repackaging and

customer service facility in New Jersey, and has 5% of its property and payroll in New Jersey, 5% of its sales of goods to locations in New Jersey, 5% of its sales of goods to locations in Ohio, and 90% of its sales of goods to locations in Pennsylvania and New York, and its only connections to Pennsylvania and New York are solicitation and delivery that are protected by P.L. 86-272, New Jersey will throw out the Pennsylvania and New York sales and compute a sales fraction of 5/10, rather than 5/100. With property and payroll fractions of 5/100 and a sales fraction of 5/10, 27.50% of that corporation's income will be attributed to New Jersey, notwithstanding that it only derived 5% of its income from New Jersey.[5] That increased attribution, *i.e.*, a factor that is more than five times higher than the activity in New Jersey as measured by property, payroll, and sales, is out of all appropriate proportion to the activity of the corporation in New Jersey. It is unconstitutional.

It is wrong for business and wrong for New Jersey. If that same corporation has, for instance, limited production capacity of 1 million widgets per year and sells 900,000 widgets in New York and Pennsylvania, and 50,000 widgets in Ohio, it would make sense for the corporation to move its New Jersey facility and sell the remaining 50,000 widgets in a state other than New Jersey,

Continued on Page 12

New California FTB Time Goals for Processing Protests

By Eric J. Coffill

On October 27, 2006, the California Franchise Tax Board ("FTB") issued two Legal Notices regarding revised time goals for the processing of docketed protests. The first of these was Notice 2006-5, which announced a pilot project allowing certain taxpayers to request a one-year timeline for resolving a docketed protest. The second was Notice 2006-6, which announced a goal under new FTB procedures to complete docketed protests within 24 months or less of the filing date of the protest. These two recent Notices are the latest developments in a long history of efforts to expedite the California protest process.

A protest is the lowest level administrative challenge to an FTB notice of proposed deficiency assessment that is issued to an individual or a corporate taxpayer. California Revenue and Taxation Code section ("section") 19041 provides that within 60 days after the mailing of a notice of proposed assessment, a taxpayer may file a protest with the FTB, specifying in the protest the grounds upon which it is based. Section 19044 provides the taxpayer a right to an oral hearing, if requested in the protest. Apart from these two sections, there are no statutory rules for protests and there are no FTB regulations which address the protest process. The protest proceedings are conducted solely within the FTB, and the same FTB employee acts as both the representative of the FTB and the protest hearing officer. Protests are assigned to one of two tracks. First, they can be assigned to a (non-attorney) hearing officer in the Audit Division. Second, they can be assigned to the Legal Department, with protests assigned to the Legal Department being denominated "docketed protests." There are no hard and fast selection criteria, but the complexity of the case and the issues, the amount of disputed tax, and workload and availability are factors which enter into the decision whether a protest is docketed.

There are no statutory or regulatory limitations upon how long a

Continued on Page 8

New California FTB Time Goals

Continued from Page 7

protest may last. However, FTB has created its own internal guidelines. In early 1999, FTB issued Notice 99-1 – now superseded by Notice 2006-6 – which stated the goal of the FTB was to evaluate the merits of a docketed protest (and any included claims for refund), conduct a hearing if required, and issue a notice of action within 33 months of the filing date of the protest.

Notice 99-1 also stated there would be circumstances where some protests were deferred and some would take longer to conclude, but such cases were intended to be the exception rather than the rule.

The two recent Notices are not the first attempt to shorten the 33-month protest period referenced in Notice 99-1. In 2000, the FTB drafted proposed regulations (proposed Regulations 19041 and 19044) addressing protests and protest hearings.[1] The efforts were spearheaded by Dean Andal, then a member of both the FTB's three-person Board and the State Board of Equalization's five-person Board. The proposed regulations would have established a 24-month period, subject to specified exceptions, for resolving protests. However, efforts to formally adopt the proposed protest regulations were abandoned later that same year, principally due to concerns over the FTB's ability to process protests under such a time-frame without additional funding. Since that time, there has been no legislative or regulatory activity regarding the protest process.

The FTB historically has had a difficult time completing docketed protests within the formerly prescribed 33-month period set forth in Notice 99-1.

The FTB historically has had a difficult time completing docketed protests within the formerly prescribed 33-month period set forth in Notice 99-1. Based on a 2004 report by the FTB to the Legislature, only 47% of corporate tax cases for that year were being completed in 33 months or less, and only 52% of such personal income tax cases were being completed in 33 months or less. Specifically, as of November 30, 2004, 68 corporate tax and 21 personal income tax docketed protests had reached the 33-month milestone without completion.[2] However, in all fairness to the FTB, the largest single reason in 2004 for its not completing cases within the 33-month target was because of protests deferred for settlement. Reassignment, attorney workload, information delay and deferrals for litigation/SBE cases were other common reasons given for not meeting the goal. Overall, FTB is quite correct in its assessment that "the long-term trends remain favorable."[3] However, there definitely remain clogs in the pipeline, as borne out by the author's experience in his practice, where a protest filed in January 2001 is *still* pending at FTB as of the time of this article; and where FTB only in January 2007 issued a decision in a protest where the hearing was held in February 2005.

NOTICE 2006-5

Turning to the first of the FTB's two recent Notices, the voluntary one-year pilot project established under Notice 2006-5 is available only for docketed protests filed on or after October 27, 2006, *i.e.*, the date of the Notice. A request to participate in the project should be included by the taxpayer in the initial protest. The FTB will then notify the taxpayer whether its protest will be included in the project within

one month of the date the protest is received. The determination whether to accept a case into the project is solely within the discretion of the FTB, and the number and complexity of the issues raised in the protest, as well as FTB resources, will enter into that decision. The project only applies to protests that involve a legal issue or issues for which "the department's litigating position is established in a Legal Ruling, an FTB Notice, a Board of Equalization decision, or a judicial decision." In addition, the protest must be limited to the adjustments made by the FTB that gave rise to the Notice of Proposed Deficiency Assessment, and the taxpayer must have "substantially responded" to information requests made during the audit regarding each item protested. Finally, if any further factual development is necessary, it must "typically be specific and limited in scope."

Taxpayers requesting to participate in the project also must agree to:

- Proceed without requesting a copy of the audit file;
- Not seek to add any issue(s) to the protest after it has been filed;
- Make a good faith effort to respond to any request for information or further explanation of their arguments within 30 days, or within one extension of not more than 15 days;
- Agree to scheduling the protest hearing at the time FTB makes initial contact; have that hearing held where the protest hearing officer is located or by teleconference; and agree not to seek to postpone a scheduled hearing; and
- Not request consideration by the FTB Settlement Bureau while the matter is in the pilot program.

FTB should be commended for creating this fast-track under Notice 2006-5, which may prove very useful to taxpayers with cases that were well developed by both parties at the audit level; where the issues are relatively few and are legal in nature as opposed to factually intensive; and where there is an interest in a speedy resolution. Business, regulatory and reporting requirements, for example, FASB Interpretation No. 48 ("FIN 48"), increasingly place pressure on companies to assess and quantify their potential state tax liabilities as expeditiously as possible.

However, there are three obvious potential pitfalls to entering the project, and an analysis will have to be made whether the relinquishment of certain rights is worth the opportunity to resolve the protest within 12 months under the pilot project. First, a taxpayer gives up the ability to obtain and review a copy of the FTB audit file in the matter. In our experience, the audit files consistently prove valuable in shedding additional light on the FTB's basis for the protest adjustments, far above and beyond the information provided by the auditor to the taxpayer during the course of the audit itself. It is routine in the author's practice to discover issues in reviewing the audit files that were not raised at audit and which often present refund opportunities or which can be used to offset tax deficiencies generated by the audit.

A second concern with the pilot project is that a taxpayer can only raise adjustments made by the FTB at audit and gives up the ability to raise additional issues in the protest after the protest has been filed. These are severe limitations. In the author's experience, additional issues frequently can and should be raised in the course of the "usual" protest proceedings, both for reasons of offsetting any deficiency adjustment and for creating overpayments and refunds. Not only might these issues be discovered by a review of the audit file, but they also may arise because of successes in other taxpayers' cases or litigation which provide a benefit to the protesting taxpayer.[4] Accordingly, should a taxpayer anticipate entering the pilot project, it is imperative to consider including all conceivable audit adjustment issues in the protest itself (with the downside risk, of course, being that a protest too heavily laden

Continued on Page 10

New California FTB Time Goals

Continued from Page 9

with issues might not be accepted by FTB into the program based on concern the case could not be completed within one year).

Finally, a taxpayer may find the limited response time of a maximum of 45 days is not sufficient to respond to all requests made by the FTB during the protest to provide further information or further explanation of arguments.

NOTICE 2006-6

This Notice states that with certain exceptions, *all* docketed protests filed after July 1, 2006, will be categorized by FTB staff as targeted to be completed within 12 months, 18 months, or 24 months. The Notice provides as follows:

- A "12-month" docketed protest is one which involves only a legal issue or issues for which the FTB's litigating position is established in a Legal Ruling, an FTB Notice, a State Board of Equalization decision, or a judicial decision. If any factual development is necessary, it will "typically be specific and limited in scope." (Note the similarity of these critera to those for the one-year pilot program established under Notice 2006-5, but without the requirement that the taxpayer make certain concessions, such as to not request a copy of the audit file or to not add additional issues to the protest once it has been filed.)
- An "18-month" docketed protest involves a limited number of legal issues, some factual development is required, or the FTB's litigating position is not established with respect to any issue in the case.
- A "24-month" protest involves more than a limited number of legal issues or legal issues of greater complexity, factual development "probably" will be required, or the FTB's litigating position is not established with respect to any issue in the case.

Under all three situations, FTB anticipates making initial contact with the taxpayer within 120 days of the filing of the protest. Both FTB staff and taxpayers are expected to make and respond to information/document requests as expeditiously as possible, with requests for extensions of time to be kept to a minimum. Protest hearings will be scheduled at an FTB office convenient to the taxpayer, when possible, or by videoconferencing or telephone.

The Notice provides new procedures for introducing issues not raised in the protest letter. Specifically, issues not raised within the 60-day protest period "ordinarily" will not be considered unless these issues can be considered and resolved within the above time-frames. The Notice states that in the alternative, taxpayers may have to raise those additional issues by filing a claim for refund, which will be addressed separately from the protest by the FTB or in an appeal to the State Board of Equalization.

The raising of "new" issues in protests has always been a complex matter. In general, taxpayers are jurisdictionally entitled at any time to raise issues to offset proposed deficiencies. However, raising additional issues which constitute claims for refunds is more complicated, for there must be an open statute for FTB to jurisdictionally address such claims. It remains to be seen how the FTB's "ordinarily" language is put into practice. The author's experience is that FTB historically has been quite willing to incorporate refund issues (assuming an open statute) or additional issues into protest proceedings for the same period when it is most efficient to do so and when the refund issues are injected into the protest early in the proceedings.

The Notice also states that once a protest hearing has been held and a determination made, docketed protests "ordinarily" will not be considered for admission into the FTB Settlement Bureau. In such cases, Settlement Bureau consideration will ordinarily be deferred until after the Notice of

Action has been issued and an appeal has been filed with the State Board of Equalization. The inference here is that as long as the protest hearing has not been held and/or a determination not yet made, protests can be considered for admission into the Settlement Bureau. However, that decision has traditionally been in the hands of the Settlement Bureau, which has extremely wide discretion whether and when to accept a case into the program. *See* FTB Notice 2006-2, Settlement of Administrative Civil Tax Matters in Dispute (Feb. 14, 2006).

Similar to the now superseded FTB Notice 99-1 that stated FTB's goal of issuing a notice of action within 33 months of the filing date of a protest, there are a litany of exceptions under Notice 2006-6 to the 12, 18, or 24 month periods. For example, deferrals may result where cases are referred back to the field because new issues were raised at protest, where other years of the taxpayer are pending in another forum, or where a potentially precedent-setting case of another taxpayer is pending in another forum. Nevertheless, an "outside" goal of 24 months is a laudable step in the right direction from the current 33-month goal.

Finally, an interesting point about Notice 2006-6 is that it appears FTB staff intends to unilaterally make the decision on "categorizing" docketed protests and then communicate that decision to the taxpayer. FTB may find a more practical approach would be to make a tentative categorization, communicate that decision to the taxpayer, and obtain a reaction. Indeed, there may be cases where both the taxpayer and the FTB will find it more efficient to mutually make the decision whether they realistically have before them a 12, 18, or 24 month case. Certainly, there are valid tactical and logistical reasons why a taxpayer may want a longer or shorter protest, or may wish to recategorize a protest based upon a change in circumstances.

A further model for FTB to explore is the system put into place by the California Trial Court Delay Reduction Act (Cal. Gov't Code §§ 68600-68620) and by the California Judicial Council (Cal. R. Ct. 3.7). There the goal is that for (unlimited) civil cases in California superior (*i.e.*, trial level) courts, 75% of cases are to be disposed of within 12 months of filing; 85% are to be disposed of within 18 months of filing; and 100% are to be disposed of within 24 months of filing. Cal. R. Ct. 3.714(b)(1). Most superior courts in California then provide local rules for implementation of these goals. For example, Sacramento County has adopted rules whereby the court first makes a determination as to the appropriate class designation of each case as Class I (12 months); Class II (18 months); or Class III (24 months). However, any party that disagrees with the court's designation may file a Designation Statement asking the court to modify the designation (to either a higher or lower class) based upon a listing of nonexclusive specified factors. Cal. Super. Ct. Sacramento County Local R. 11.06. FTB should consider adding such a Designation Statement process to its new protest timelines under Notice 2006-6. ■

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[1] *See* FTB Notice 2000-2 (Feb. 11, 2000) (announcing a Symposium to discuss proposed regulations); FTB Notice 2000-3 (April, 17, 2000) (announcing a second Symposium).

[2] Cal. Franchise Tax Bd., *Rep. on Status of Franchise Tax Bd. Docketed Protest Case Inventory,* at 13-14 (2004).

[3] *Id.* at 12.

[4] For example, many taxpayers received or will receive "gross receipts" sales factor benefits under *Microsoft Corp. v. Franchise Tax Board,* 139 P.3d 1169 (Cal. 2006); water's-edge calculation benefits under *Fujitsu IT Holdings, Inc. v. Franchise Tax Board,* 15 Cal. Rptr. 3d 473 (Cal. Ct. App. 2004), *review denied,* S127167 (Cal. Oct. 20, 2004); section 24402 dividend deduction benefits under *Farmer Bros. v. Franchise Tax Board,* 134 Cal. Rptr. 2d 390 (Cal. Ct. App. 2003), *cert. denied,* 540 U.S. 1178 (2004); and (probably) LLC levy benefits under *Northwest Energetic Services, LLC v. Franchise Tax Board,* No. CGC-05-437721 (Cal. Super. Ct. San Francisco County Apr. 13, 2006).

P.L. 86-272

Continued from Page 7

a state that will not treat it so harshly. Assuming the corporation has a market for its remaining widgets outside New Jersey, the corporation would not lose – it would still sell all of its widgets. The citizens of New Jersey would lose. They would lose the jobs at the New Jersey repackaging and customer service facility and would lose the benefits of competition. The lost competition would reduce choice in New Jersey, would decrease competition, and would allow competitors to charge more money for the competitive version of the widget sold in New Jersey. Furthermore, purchasers of those widgets would have unnecessary burdens which could have additional implications.

For example, if the widgets are copper pipes (substitute testing equipment for copper pipes in the example, and a low-technology problem becomes a high-technology problem). The cost of pipes may rise to the extent that small plumbing businesses could no longer afford to carry sufficient amounts of pipes on their trucks. The additional time spent and gasoline consumed to travel to a supply house to purchase needed pipes added to the cost of pipes could force some small businesses to close, thereby reducing prosperity and employment. Further, if the supply of copper pipes were to be reduced in New Jersey, smaller plumbing businesses without the ability to leave the state to purchase pipes or without sufficient volume to demand that the pipes be shipped to New Jersey may be forced to turn down jobs from paying customers. These examples may be at the margin and a bit simplistic. However, they are illustrative.

New Jersey interprets the throwout law, which removes from the denominator of the sales fraction sales that are assigned to a state "in which a taxpayer is not subject to tax on or measured by profits or income, or business presence or business activity," to mean that if a corporation is "not subject to tax in other states due to the protection of P.L. 86-272," then the corporation is subject to throwout of receipts attributable to those states in which the corporation is protected by P.L. 86-272. N.J. Admin. Code 18:7-8.7(d) (Example). The example in the regulation shows the sample allocation factor rising from 55% to 65% on the same business activity. New Jersey has no reservation about demonstrating its entitlement to a larger share of the proverbial pie if other states are prohibited from eating or decline to eat their share of the pie.

NEW JERSEY IS ADVERSARIAL TO BUSINESS

New Jersey has said, in so many words, that it will get P.L. 86-272-protected corporations for protected activities in New Jersey and it will get P.L. 86-272-protected corporations for protected activities in other states. The fundamental basis of its position is that P.L. 86-272 does not say that New Jersey cannot use such a "loophole." The type of "loophole" that New Jersey favors for apportionment is precisely the type of "loophole" that New Jersey claims separate corporations should not be able to use for nexus.

If a corporation that is protected from taxation in New Jersey by P.L. 86-272 is hit with the AMA or if it is subject to throwout of P.L. 86-272-protected sales once in New Jersey, then why should business leaders think that corporations will be treated any better if jobs are added in New Jersey? As Dean Hughes and Professor Seneca noted, corporate leaders have demonstrated that they know how to add jobs in California, Georgia, North Carolina, Texas, and Virginia.

Let us hope that New Jersey can be exposed for its whipsaw of corporations

and that once exposed will eliminate the AMA for all corporations and will respect P.L. 86-272 protection afforded in other states. There has to be a better way for New Jersey to grow. New Jersey should do the right thing. ■

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[1] The first priority in the Governor's action plan is to create a "single account management team to provide outreach and support to businesses seeking to expand within or relocate to New Jersey." Jon S. Corzine, *Economic Growth Strategy for the State of New Jersey 2007*, at 12. Before acting on any proposals from the account management team, corporations should ask what the tax impact would be if the account management team's proposal is followed.

[2] New Jersey has been a separate-entity state since before the imposition of the CBT in 1945. N.J. Stat. Ann. 54:10A-1 *et seq.* (L. 1945, c. 162). The CBT replaced two taxes. The tax on domestic corporations arose in 1906, N.J. Stat. Ann. 54:13-1 *et seq.*, and the tax on foreign corporations arose in 1937, N.J. Stat. Ann. 54:32A-1 *et seq.*

[3] *See, e.g.*, *Lanco, Inc. v. Director, Division of Taxation,* 188 N.J. 380 (2006) (certiorari to be requested). However, for apportionment purposes, when New Jersey applies its throwout provisions, *i.e.*, removes from the denominator of the receipts fraction sales that are not "subject to tax" in another state, N.J. Stat. Ann. 54:10A-6(B)(6), it will not assume that its nexus position applies in other states.

[4] The AMA is based on gross receipts or gross profits. Initially, the AMA applied to all corporations that are subject to tax in New Jersey. For privilege periods commencing after June 30, 2006, the AMA is reduced to zero for all taxpayers except taxpayers that are protected by P.L. 86-272. However, for privilege periods commencing after December 31, 2006, if a taxpayer that is protected by P.L. 86-272 consents to jurisdiction under the normal CBT (i.e., waives the protections afforded to it under federal law), that corporation's AMA liability will be zero. N.J. Stat. Ann. 54:10A-5a(e).

[5] The property and payroll fractions would each be 5/100. The sales fraction would be 5/10. The computation would be (0.0500 + 0.0500 + (2 x 0.5000))/4 or 27.50%. N.J. Admin. Code 18:7-8.1(c).

This article is adapted from an article that appeared in State Tax Notes.

Sales Factor Gross Receipts Cases Addressed by the California Supreme Court

By Carley A. Roberts

After years of litigation and speculation, the California Supreme Court issued its decisions in *Microsoft Corp. v. Franchise Tax Board*, 139 P.3d 1169 (Cal. 2006) ("*Microsoft*") and *General Motors Corp. v. Franchise Tax Board*, 139 P.3d 1183 (Cal. 2006) ("*General Motors*"). Both cases presented the Revenue and Taxation Code section ("section") 25120 "gross receipts" issue and the section 25137 "distortion" issue. The decisions will unquestionably have varied and widespread effects on many taxpayers doing business in California.

The court treated *Microsoft* as the lead opinion on the gross receipts and distortion issues. The court framed the two issues as follows: (1) whether the redemption of marketable securities at maturity generates "gross receipts" (or, alternatively, the net price difference) includible in the sales factor; and (2) if so, whether the FTB met its burden of showing section 25137 should be applied. In *General Motors*, the court addressed another gross receipts issue not present in *Microsoft*: how repurchase agreements ("repos") are to be treated for sales factor purposes.

In short, the court ruled in *Microsoft* that: (1) the redemption of marketable securities at maturity does generate gross receipts for sales factor purposes; and (2) the FTB did meet its burden under section 25137, and an alternative apportionment formula should be used. In *General Motors*, the court ruled repos have the characteristics of loans and therefore only the interest received is a gross receipt for purposes of section 25120.

THE COURT'S SECTION 25120 "GROSS RECEIPTS" ANALYSIS

Microsoft and General Motors separately argued the entire gross proceeds from certain treasury function transactions must be included in their respective sales factor as "gross receipts" under section 25120. Microsoft's transactions mainly included marketable securities held to maturity, while General Motors' transactions included both marketable securities held to

Continued on Page 21

California's LLC Tax

Continued from Page 5

of the Court of Appeal's decision in *NMI*.

SECTION 17942

The levy imposed by section 17942 is referred to as an "annual fee" by the statute, and it is imposed on "every limited liability company subject to tax under Section 17941."[7] The amount of the levy ranges from a minimum of $900 to a maximum of $11,790 per year.[8]

As discussed in detail below, section 17942 is problematic in that it applies to any LLC that either does business in California or has simply registered to do business in California, and its rate is applied without regard to the amount of business the taxpayer actually does within the state during a given year.[9]

RECENT LITIGATION

Northwest Energetic Services, LLC v. Franchise Tax Board

In *Northwest*, the Superior Court for the City and County of San Francisco awarded plaintiff Northwest Energetic Services ("NES") a refund of $27,458.13, the total amount it had paid pursuant to section 17942 for tax years 1997, 1999, 2000, and 2001. The plaintiff, an LLC, was in the business of distributing explosives and explosive-related services. The plaintiff maintained business locations in Washington and Oregon only, and had no business activity, property, inventory, employees, or customers in the State of California. Nevertheless, it was subject to section 17942's levy by virtue of having registered to do business in California with the Secretary of State in 1997.

NES paid California's flat $800 minimum franchise tax under section 17941 for the four years at issue. However, NES did not pay anything under section 17942 until 2002, when the FTB notified NES that it owed a total of $27,458.13, including penalties and interest under the LLC fee provision. NES paid the full amount in order to receive a Tax Clearance Certificate, then promptly cancelled its registration in California and sought a refund of the taxes paid, which the FTB denied. On administrative appeal, the State Board of Equalization upheld the denial of NES's refund claim. Having exhausted its available administrative remedies, NES filed suit challenging the constitutional validity of section 17942, both on its face and as applied. At trial, NES argued that the levy was a tax, not a fee, and that the tax was unconstitutional because it was not apportioned. The FTB maintained that section 17942 imposed a regulatory fee rather than a tax, and therefore it need not be apportioned, on the grounds that LLCs voluntarily decide how to organize and whether to register in California in exchange for privileges and benefits afforded by the state. The trial court decided in favor of the taxpayer on both issues.

The court first determined that section 17942 imposes a tax and not a fee, despite the fact that the statute refers to the levy as an annual "fee." The court explained that the determination of whether a levy is a fee or a tax is based upon its operation and intent, not upon its label. Taxes raise revenue for the state's general use, whereas fees are paid into specialized funds associated with a particular state service. Furthermore, fees serve to reimburse the state for specific costs associated with providing some benefit, service, or regulation, and cannot require the collection of more than the amount reasonably necessary to cover the cost of the state's regulatory activities.[10]

The court reviewed the legislative history underlying section 17942 and

determined that the primary purpose of the levy was to replace lost corporate income tax revenue. When the California Limited Liability Company Act ("LLC Act"), S.B. 469, which recognized limited liability companies as legal entities in California, became effective in 1994, the legislature added section 17942 to offset the anticipated drop in corporate income tax revenue. The legislature deliberately set the amount of the levy so that it would make up for the projected decrease in corporate income tax revenues from businesses deciding to operate as LLCs rather than as corporations in California. The court found support for its conclusion that the levy is a tax in the fact that the levy generates far more revenue than necessary to support the state's administrative activities related to regulating and administering LLCs. Furthermore, the court noted that the revenue generated by the levy goes into California's general fund, not toward the state's regulation or administration of LLCs. For these reasons, the court held that the FTB had not met its burden of proving that the levy was a regulatory fee rather than a tax.[11]

Having found that the levy imposed by section 17942 was not a fee but a tax, the trial court ruled that, as applied to NES, section 17942 violates the United States Constitution's fair apportionment requirement.[12] The court stated: "A fundamental constitutional principle governing state taxation . . . is that a state tax must be fairly apportioned, *i.e.*, it must be calibrated to the level of activity in the State."[13]

Grounded in Commerce Clause and Due Process principles, the requirement of fair apportionment is a two-fold requirement. First, the fair apportionment requirement mandates that a state tax place no greater burden on interstate commerce than

Continued on Page 16

LLC Fee Refund Procedures

The FTB has posted the procedure for filing a protective claim for refund of fees paid pursuant to California Revenue & Taxation Code Section 17942 at:

http://www.ftb.ca.gov/professionals/taxnews/article/llcfee.html.

The FTB's website states that to file a protective claim pending the final outcome of litigation, an LLC should fax a letter to the FTB containing the following information:

- The name of the LLC and the identification number issued by the Secretary of State (unregistered LLCs should use the identification number issued by the FTB).
- A statement indicating that the LLC is filing a protective claim for refund.
- The tax years involved.
- The amount of the claim, which should match the amount of the annual fee that the LLC paid.
- A description of the issue (stating that the LLC fee is unconstitutional is sufficient).
- The name of a contact person and that person's phone number and fax number.

The letter must be signed by a representative with power of attorney or by the LLC's managing partner. We recommend that a taxpayer who may wish to file a claim for refund consult with counsel, to ensure that its claim is complete and timely filed within the statute of limitations.

California's LLC Tax

Continued from Page 15

on intrastate commerce.[14] Second, it forbids states from taxing any income not attributable to in-state economic activity.[15]

The court found that the unapportioned levy violated both prongs of the fair apportionment requirement. First, the levy burdened interstate commerce as compared to intrastate commerce because if every state enacted a statute identical to section 17942, LLCs registered to do business in multiple states would pay more tax overall than LLCs doing business in only one state.[16] Second, since section 17942 required NES to pay California taxes despite the fact that it had not done business in the state, the levy "undeniably" reached beyond NES's income attributable to business activities within California.[17]

The court found that the unapportioned levy violated both prongs of the fair apportionment requirement.

Although the facts in *Northwest* were extremely favorable to the plaintiff, as the taxpayer had no sales, property, or employees in California, the FTB filed notice on July 5, 2006, of its intent to appeal the trial court's decision.[18] The California Court of Appeal for the First Appellate District sitting in San Francisco will review the case on appeal.

Ventas Finance I, LLC v. Franchise Tax Board

Ventas involved the same apportionment issue as *Northwest*. However, the facts of *Ventas* were somewhat different, since the plaintiff in *Ventas* carried on a small amount of business in California, while NES had none.

Ventas, an LLC organized under Delaware law with its headquarters in Louisville, Kentucky, sued for a refund of payments it made under section 17942 based on the grounds that the amounts paid were disproportionate to the amount of Ventas's business activities in California. Ventas's complaint alleged that if California's corporate franchise tax apportionment methodology were applied, Ventas's California apportionment percentage would have been 8.06%, 8.34%, and 6.94% in the years 2001, 2002, and 2003, respectively.[19] However, pursuant to section 17942, the tax base for Ventas's LLC tax was its total worldwide gross receipts and it paid levies of $6,000 in 2001 and of $11,790 (the maximum possible) for each of the years 2002 and 2003. Like the plaintiff in *Northwest*, Ventas filed an administrative claim for refund, which was denied. Ventas's lawsuit sought a refund in the amount of $29,540, plus interest and attorneys' fees.[20] The FTB's answer again maintained that the levy imposed by section 17942 was a fee, not a tax. As noted above, the *Northwest* court expressly rejected that contention.

The court in *Ventas* again determined that the levy imposed pursuant to section 17942 was a tax, not a fee. The court made this determination on the same grounds as it had in *Northwest*; namely, that the purpose of the levy is to raise revenue and that the revenue raised was used for general purposes, not to fund the regulation of LLCs. The court then found that the levy imposed by section 17942 was unconstitutional as applied to Ventas because it was not fairly apportioned. Lastly, the court held that section 17942 could not be reformed because "[a]dding

an apportionment mechanism as [the Franchise Tax Board] suggests would run contra to the Legislature's expressed intent" because the legislative history of section 17942 "establishes that the Legislature considered and rejected apportionment" of the levy.

While the facts in *Ventas* differed from those in *Northwest*, the Commerce Clause analysis was the same in each case. The *Northwest* court found that section 17942 burdened interstate commerce more than intrastate commerce because if every state enacted a statute identical to section 17942, LLCs registered to do business in more than one state would have greater overall tax liability than those choosing to do business in only one state. This would be true regardless of whether a particular plaintiff conducts a small amount of business, as opposed to none at all, in California. Under a fair apportionment tax statute, Ventas would have to pay some LLC tax in California by virtue of having done some business there, but presumably the apportioned amount would be less than the amounts it paid for tax years 2001 through 2003 pursuant to the unapportioned tax based on its worldwide business.

The final decision in the *Northwest* appeal should determine the fate of section 17942 as currently written. If the trial court's decision is upheld on appeal, LLCs registered to do business in California will not be subject to the unapportioned levy on a going forward basis, and LLCs that paid the unapportioned tax in past years will be able to claim refunds for those payments. However, the proposed retroactive provision in A.B. 1614 had made it unclear whether those taxpayers would be entitled to full refunds of all amounts paid under section 17942, or whether they would be limited to claiming amounts paid in excess of the apportioned tax A.B. 1614 sought to create.

PROPOSED CHANGES TO SECTION 17942

Retroactive Apportionment

Recognizing that *Northwest* could very well be upheld on appeal, the California Senate and Assembly passed A.B. 1614, which contained proposed revisions to section 17942, including an apportionment provision that would have modified section 17942 to bring it in line with constitutional fair apportionment requirements. However, with little forewarning, Governor Schwarzenegger vetoed the bill on September 30, 2006.

Had it been signed by the Governor, the modified statute would have defined "total income from all sources reportable to this state" to mean gross income plus the cost of goods sold, but only to the extent that such income and sales are "derived from or attributable to" the State of California. The proposed revisions also would have provided that LLCs would calculate their income derived from or attributable to the state according to the general apportionment provisions in sections 25101 *et seq.*, which apply to state income and franchise taxes.[21]

However, the proposed statutory revision was problematic in that it would have applied to taxpayers retroactively starting for the 2001 tax year. While the apportionment of the

Continued on Page 18

> Therefore, taxpayers should be entitled to refunds of the full amounts previously paid under section 17942, not just the amounts paid over and above the tax they would have paid had it been fairly apportioned at the time.

California's LLC Tax

Continued from Page 17

LLC fee under A.B. 1614 might have rectified the constitutional infirmity identified in *Northwest*, retroactive changes present constitutional problems of their own, as explained in *NMI*.

The underlying issue in *NMI* was similar to that in *Northwest*, although *NMI* involved an unapportioned municipal business license tax rather than a statewide tax. While the California Constitution does not contain an explicit commerce clause, courts have found nevertheless that municipal taxes discriminating against intercity commerce are unconstitutional under due process and equal protection principles.[22] Whereas the taxpayer in *Northwest* sued for a refund of taxes paid, in *NMI* the City of Modesto was attempting to collect an alleged business tax deficiency from the taxpayer. At trial, the court rejected the City's claim, finding the business license tax unconstitutional as applied to NMI because it was unapportioned and, thus, it unfairly taxed income earned outside the City. On appeal, the City did not deny that its tax as originally drafted was unconstitutional, but instead asked the court to sanction a retroactive legislative change that would allow it to pursue its claim against NMI, albeit for a reduced amount that would reflect NMI's apportioned business within the City.

In addition to finding that the plain language of the City's tax ordinance restricted the retroactive application sought by the City,[23] the court in *NMI* invalidated the retroactive apportionment provision of the business license tax on constitutional due process grounds. The City argued that retroactively apportioning the business license tax would not threaten the plaintiff's right to due process, because it could only have the effect of lowering a taxpayer's liability. The court, however, pointed out that due process requires that taxpayers have "a fair opportunity to challenge the accuracy and legal validity of their tax obligation and also a clear and certain remedy for any erroneous or unlawful collection."[24] The court noted that retroactive application of the apportionment provisions would have required NMI to prove which of its gross receipts were earned outside the City and thus not includable in the tax base of the City's business license tax.[25] Because the retroactive provision, enacted in 2004, would have applied as far back as 1996, taxpayers in NMI's position would have had to produce records eight or nine years old to avoid being unconstitutionally taxed on income earned outside the City. The court held that this was a far cry from a "clear and certain remedy," and that it placed an unfair burden on the taxpayer to correct the City's error in originally drafting an unapportioned tax. Notably, the court also stated that California courts generally allow retroactive changes to tax laws only if they are limited *to the current tax year*.[26]

Under the due process analysis in *NMI*, the Legislature's proposed changes to section 17942 probably would not have been able to withstand constitutional challenge. In order to avoid being forced to pay unapportioned taxes, taxpayers like NES and Ventas would have been required to produce out-of-state business records from tax years 2001 forward that they had no obligation to retain. The *NMI* court found this requirement unfair to taxpayers, who must have fair notice of any record-keeping obligations required to establish a constitutional right.[27]

Furthermore, the retroactive apportionment of the levy under section 17942 would have applied as of 2001, a retroactive period of five years.

As noted above, the *NMI* court cited *Gutknecht* and *Carlton* in support for the general rule that California courts allow "retroactive application of tax laws only where such retroactivity [is] limited to the current tax year."[28]

However, there are reasons to be cautious about the application of *NMI*'s "current year" rule. First, the majority in *Carlton* did not establish a bright-line rule regarding the allowable length of retroactivity periods. Instead, it was Justice O'Connor's concurring opinion that stated that a "period of retroactivity longer than the year preceding the legislative session in which the law was enacted would raise . . . serious constitutional questions."[29] Second, *Gutknecht* is at least arguably limited to its facts – *i.e.*, retroactive increases in the tax rate – and may not apply to A.B. 1614, which attempted to rectify the constitutional infirmity of an existing statute. Further, *Gutknecht* was decided prior to *Carlton*, and there do not appear to be any California cases other than *NMI* that interpret *Carlton* with respect to retroactivity of tax legislation. Third, in 1996 the Ninth Circuit Court of Appeals, which has jurisdiction over federal cases in California, held that there was no due process violation for federal legislation applying retroactively for

California has already established an administrative process for LLCs to file protective refund claims in the wake of the Northwest decision.

approximately three years because the legislation was supported by a legitimate legislative purpose furthered by rational means.[30] In other words, while *NMI* suggests that California courts will allow retroactive application of tax legislation only if it is limited to the current tax year, it is possible that a court could allow a longer retroactivity period.

In *NMI*, the City was barred from collecting tax under a statute that was unconstitutional during the years at issue in the lawsuit. Based on the reasoning of the court in *NMI*, California should not be allowed to apply an apportionment provision retroactively and collect an apportioned tax under section 17942, since the tax was unconstitutional when paid. Therefore, taxpayers should be entitled to refunds of the full amounts previously paid under section 17942, not just the amounts paid over and above the tax they would have paid had it been fairly apportioned at the time.

Taxpayer Remedies

California has already established an administrative process for LLCs to file protective refund claims in the wake of the *Northwest* decision. Taxpayers who plan to seek refunds should file protective claims immediately, despite the possibility that *Northwest* will be reversed on appeal, as the statute of limitations to file claims for refund will expire within four years of when the tax was paid.[31] ■

[1] All references to "section" are to the California Revenue and Taxation Code, unless otherwise noted.

[2] Taxpayers and the FTB disagree as to whether section 17942 imposes a "fee" or a "tax." For simplicity, we will follow the *Northwest* court's practice and use the term "levy."

[3] Case no. CGC-05-437721; final decision issued on April 18, 2006.

[4] Case no. CGC-05-440001; tentative decision issued on November 7, 2006.

[5] 27 Cal. Rptr. 3d 215 (Cal. Ct. App. 2005).

[6] On September 30, 2006, Governor Schwarzenegger vetoed A.B. 1614, noting that the validity of section 17942 was pending before the courts. While A.B. 1614 appears now to be defunct as a result of the Governor's veto, the retroactivity problems it raised are sure to arise again in future legislative amendments, and thus, are still worthy of analysis.

[7] Section 17941 imposes a separate levy on every limited liability company "doing business in [California] (as defined in Section 23101)." Pursuant to section 23101, "doing business"

Continued on Page 20

California's LLC Tax

Continued from Page 19

means "actively engaging in any transaction for the purpose of financial or pecuniary gain or profit."

[8] The amount owed depends on the taxpayer's "total income from all sources reportable to [California] for the taxable year," which both taxpayers and the FTB have construed to mean gross receipts earned anywhere in the world.

[9] Readers should note that the section 17942 levy is separate from, and in addition to, the $800 per year flat minimum franchise tax imposed on LLCs under section 17941.

[10] *See Sinclair Paint Co. v. State Bd. of Equalization*, 937 P.2d 1350, 1353 (Cal. 1997).

[11] The court held that the burden of proving the levy is a fee rather than a tax falls on the State, though the plaintiff retains the overall burden of proving the unapportioned levy is unconstitutional.

[12] The *Northwest* court held that, even if it had deemed the levy a fee, "it would be subject to the fair apportionment requirement of the Commerce and Due Process Clauses of the United States Constitution." In support, the court cited *American Trucking Ass'ns v. Scheiner*, 483 U.S. 266, 285 (1987) (in which the U.S. Supreme Court applied constitutional apportionment requirements to an annual identification marker fee assessed on each vehicle of certain weight classes operating on the state's highways), and *American Trucking Ass'ns, Inc. v. Michigan Public Service Comm'n*, 545 U.S. 429 (2005) (in which the Court applied constitutional apportionment requirements to a flat $100 annual fee on trucks engaged in intrastate commercial hauling).

[13] Under *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274, 279 (1977), a levy on interstate commerce must be "fairly apportioned."

[14] *See, e.g., American Trucking Ass'ns v. Scheiner*, 483 U.S. 266 (1987); *American Trucking Ass'ns v. New Jersey*, 852 A.2d 142 (N.J. 2004).

[15] *See Oklahoma Tax Comm'n v. Jefferson Lines, Inc.*, 514 U.S. 175 (1995) (holding that a traditional sales tax need not be apportioned even when applied to the gross proceeds of an interstate service, but that gross receipts or gross income taxes do require apportionment).

[16] The court thus applied what the United States Supreme Court labeled the "internal consistency" test in *Jefferson Lines*. *See Jefferson Lines*, 514 U.S. at 184.

[17] This, the court said, violated the "external consistency" test of *Jefferson Lines*. *Id.* at 184.

[18] The Notice of Appeal was filed with the Court of Appeal on August 8, 2006. The appellant's opening brief is due on December 12, 2006.

[19] When a corporation conducts taxable business activities both inside and outside of California, that corporation must apportion its taxable business income based upon the apportionment formula laid out in sections 25128 *et seq*. Pursuant to section 25128, a taxpayer's apportionment percentage is equal to the sum of (1) the taxpayer's property factor, (2) the taxpayer's payroll factor, and (3) two times the taxpayer's sales factor, divided by four.

[20] The body of plaintiff's complaint alleged payments totaling $29,580, but the prayer for relief asked for $29,540.

[21] *See* note 20, above.

[22] *See City of Los Angeles v. Shell Oil Co.*, 480 P.2d 953 (Cal.), *cert. denied*, 404 U.S. 831 (1971).

[23] Until NMI filed its trial brief, the City's amended business license tax ordinance provided for retroactive apportionment only in the context of taxpayer refund claims. After NMI filed its trial brief, the City added a retroactive apportionment provision that would have applied to deficiency assessments initiated by the City, including the deficiency assessment at issue in the underlying suit against NMI. The trial court disallowed the retroactive change because the new apportionment provision constituted a substantive change to the ordinance, and the City's tax ordinance itself provided that only procedural changes could apply retroactively.

[24] 27 Cal. Rptr. 3d at 223 (citing *McKesson Corp. v. Florida Alcohol & Tobacco Div.*, 496 U.S. 18 (1990) (internal quotations omitted)); *see also Atchison, Topeka & Santa Fe Ry. v. O'Connor*, 223 U.S. 280, 285 (1912).

[25] *Id.*

[26] *Id.* at 222 (citing *Gutknecht v. City of Sausalito*, 117 Cal. Rptr. 782 (Cal. Ct. App. 1974)); *see also United States v. Carlton*, 512 U.S. 26 (1994).

[27] *See, e.g., Patel v. City of Gilroy*, 118 Cal. Rptr. 2d 354, 357 (Cal. Ct. App.), *cert. denied*, 537 U.S. 1072 (2002) ("A tax law in particular 'must prescribe a standard sufficiently definite to be understandable to the average person who desires to comply with it.'" (citation omitted)).

[28] 27 Cal. Rptr. 3d at 222.

[29] 512 U.S. at 38 (O'Connor, J., concurring).

[30] *Montana Rail Link, Inc. v. United States*, 76 F.3d 991, 995 (9th Cir. 1996).

[31] The authors would like to acknowledge the substantial contributions to this article made by Naomi Ogan, who was a summer associate in Morrison & Foerster LLP's San Francisco office in 2006.

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Sales Factor Gross Receipts

Continued from Page 13

maturity and repurchase agreements. The Supreme Court concluded in both cases the entire gross receipts from marketable securities held to maturity are to be included in the sales factor, but that only interest from repurchase agreements is to be included in the sales factor.

Microsoft addressed the issue in the context of marketable securities. First, the court in *Microsoft* stated that the meaning of "gross receipts" in section 25120 "more naturally includes the entire redemption price of marketable securities." *Microsoft,* 139 P.3d at 1174. The court stated that inclusion of only the net difference as gross receipts "is an awkward fit with the statutory language, at best." *Id.* Second, the court stated the legislative history behind section 25120 supports inclusion of marketable securities held to maturity as gross receipts. Section 25120 is part of the Uniform Division of Income for Tax Purposes Act ("UDITPA"), which a number of states, including California, have adopted to determine multistate taxpayers' apportioned income. The court noted that an early version of the UDITPA defined "sales" as "all income of the taxpayer" not otherwise allocated, but this provision was amended to define "sales" instead as "all gross receipts of the taxpayer" not otherwise allocated. *Id.* Third, the Court stated that inclusion of the entire gross proceeds is also supported by the State Board of Equalization's interpretation of gross receipts to include the full amount of any redemptions ("albeit in a more limited fashion"). *Id.* at 1175. Fourth, the Court looked to the "economic reality" of the taxed transaction and concluded "the full redemption price, like the full sale price, must be treated as gross receipts" under section 25120. *Id.* Accordingly, the court in *Microsoft* held the entire redemption price of marketable securities is included within the statutory meaning of "gross receipts." *Id.* at 1174.

General Motors addressed the issue in the context of repos. The court in *General Motors* concluded that although repos are truly "hybrids" that blend characteristics of both a sale of securities and a secured loan, for gross receipts purposes, a repo has the characteristics of a loan. Thus, the court held only the interest received on a repo is a gross receipt for purposes of the sales factor. *General Motors,* 139 P.3d at 1192.

THE COURT'S SECTION 25137 "DISTORTION" ANALYSIS

Having concluded in *Microsoft* the full redemption price constitutes gross receipts, the court turned to the application of the alternative apportionment provisions of section 25137. Section 25137 provides, in pertinent part, that if the allocation and apportionment provisions of the UDITPA (*i.e.,* sections 25120 through 25139) do not "fairly represent the extent of the taxpayer's business activity in this state," the taxpayer may petition for or the FTB may require, "in respect to all or any part of the taxpayer's business activity, if reasonable," separate accounting, the inclusion or exclusion of one or more factors, or "the employment of any other method to effectuate an equitable allocation and apportionment of the taxpayer's income."

Before addressing whether the alternative apportionment provisions of section 25137 applied to the facts of the case, the court addressed the issue of which party bears the burden of proof under section 25137. Although FTB was the party seeking application of section 25137, it had nonetheless argued the taxpayer bears the burden of proof. The court found that FTB, as the party invoking section 25137, bears the burden of proving by clear and convincing evidence that: (1) the approximation provided by the standard formula is not a fair representation; and (2) its proposed alternative is reasonable. *Microsoft,* 139 P.3d at 1177. The court concluded that FTB met its burden of proof "in this instance." *Id.*

Continued on Page 22

Sales Factor Gross Receipts

Continued from Page 21

Section 25137 permits deviation from the standard allocation and apportionment provisions of UDITPA only where they "do not fairly represent the extent of the taxpayer's business activity in this state." The court in *Microsoft* considered the conditions under which the inclusion of a particular treasury activity in the standard apportionment formula would produce distortion sufficient to invoke section 25137. The result of the court's analysis is both a qualitative and quantitative analysis of the business activity in question. *Id.* at 1178.

As part of the qualitative analysis, the Court drew a distinction between the business activity in question, *i.e.,* Microsoft's treasury department transactions, and the core business of Microsoft in order to determine whether the activity in question is a fundamental part of, or incidental to, the primary business. *Id.*

For business activities which are a part of the taxpayer's core business, the Court cited with approval the quantitative analysis in the State Board of Equalization's (SBE) decision in *Appeal of Merrill, Lynch, Pierce, Fenner & Smith, Inc.,* 89-SBE-017 (SBE June 2, 1989) ("*Merrill Lynch*"). In *Merrill Lynch*, the FTB objected to inclusion of full gross receipts for securities bought as a principal/underwriter, but the SBE rejected that argument. In rejecting the FTB's arguments, the SBE compared the standard apportionment formula with the proposed alternate formula. The SBE determined that Merrill Lynch's sale of securities on its own account was not qualitatively different from its main business, and the resulting quantitative difference between the standard formula and the Board's proposed formula was on the order of 23 to 36 percent. No quantitative distortion was found to exist in *Merrill Lynch*.

For business activities which are not a part of the taxpayer's core business, the Court cited with approval the quantitative analysis in the SBE's decision in *Appeals of Pacific Telephone & Telegraph Co.,* 78-SBE-027 (SBE May 4, 1978) ("*PacTel*"). In *PacTel*, the taxpayer argued it was entitled to include the full gross receipts from its treasury department's investments in the sales factor. The investments produced less than 2 percent of the company's business income, but 34 percent of its gross receipts. The SBE described the sales factor as intended to "reflect the markets for the taxpayer's goods or services" and asked whether inclusion of all investment receipts would serve that function. The SBE answered in the negative, holding the "inclusion of this enormous volume of investment receipts substantially overloads the sales factor in favor of New York, and thereby inadequately reflects the contributions made by all the other states, including California, which supply the markets for the . . . services provided by [the taxpayer]." Quantitatively, the SBE stated that since the treasury department's gross receipts constituted approximately 34 percent of total gross receipts, inclusion of such receipts would result in approximately one third of the taxpayer's total sales, and therefore at least 11% of the taxpayer's total business activities being apportioned to New York where the treasury function was located. The SBE stated, "we are unable to accept, even for a moment, the notion that more than 11 percent of [the taxpayer's] entire unitary business activities should be attributed to any single state solely because it is the center of working capital investment activities that are clearly only an incidental part of one of America's largest, and most widespread, businesses."

The court in *Microsoft* also focused upon treasury department distortion arising from differing margins (*i.e.,* differences between cost and sale price) that may be several orders of magnitude different than those for other commodities of the business. 139 P.3d at 1179. The court stated that modern treasury departments whose operations are qualitatively different from the rest of a corporation's business and whose typical margins may be quantitatively several orders of magnitude different from the rest of a

corporation's business pose a problem for the apportionment formula. *Id.* The court underscored the qualitative recognition that the different nature of short-term investments means that mixing short-term receipts with gross receipts from other types of business activities involves an "apples-to-oranges" comparison that may require correction under section 25137. *Id.* at 1180.

Applying section 25137 to the facts in *Microsoft*, the court concluded mixing the gross receipts from Microsoft's short-term investments with the gross receipts from its other "core" business activity "seriously distorts the standard formula's attribution of income to each state." *Id.* at 1181. The *Microsoft* Court held:

> These transactions generated minimal income (just under 2 percent of Microsoft's business income for 1991) but enormous receipts (approximately 73 percent of gross receipts for 1991). Their inclusion in the standard formula would result in reducing roughly by half the estimated income attributed to California, and likely every state other than Washington, depending on the property and payroll factors. The distortion the Board has shown here is of both a type and size properly addressed through invocation of section 25137; application of the standard formula does not fairly represent the extent of Microsoft's business in California.

Id.

Finally, the court in *Microsoft* observed that any proposed alternative solution under section 25137 must be reasonable. The court held that "[b]ecause the net receipts are so small in comparison with Microsoft's nontreasury income and receipts," the inclusion of net receipts instead of gross receipts was reasonable. *Id.* The court cautioned, however, that "mixing net receipts for a particular set of out-of-state transactions with gross receipts for other transactions . . . minimizes the contribution of those out-of-state transactions," and in other cases this approach "may go too far in the opposite direction and fail the test of reasonableness." *Id.*

In *General Motors*, the court ordered the case be remanded to the lower courts to allow the FTB "to make its section 25137 case" in accordance with the principles set out in Microsoft. *General Motors*, 139 P.3d at 1193. *General Motors* was remanded shortly after the FTB's petitions for rehearing were denied by the Court, in both cases, in late October 2006.

WHERE DO WE GO FROM HERE?

Neither *Microsoft* nor *General Motors* is a clear victory for the parties or the many taxpayers waiting for the decisions. Both cases raise important issues that will likely affect many taxpayers doing business in California. The California Supreme Court has not publicly expressed an across-the-board approach that will determine the answer in every case. Depending on the particular facts and circumstances of the individual taxpayer, the resolution may vary significantly. Further litigation may ensue as a result of the court's section 25137 analysis and its application in particular cases.

A legislative fix could also be on the horizon for the gross receipts and distortion issues. The court welcomed the California Legislature "to follow [the] leads" of other states that have amended their sales factor statutes to expressly exclude investment returns of capital from the definition of gross receipts. *Microsoft,* 139 P.3d at 1182. Assembly Bill ("A.B.") 1037, which would have prospectively changed the treatment of investment returns of capital under the UDITPA, did not pass in the 2005-2006 California legislative session. *See* A.B. 1037, 2005-06 Leg., Reg. Sess (Cal. 2006). It is yet to be determined whether a similar bill will be introduced in the next legislative session. ■

Welcome!

Morrison & Foerster's State and Local Tax Group would like to welcome Scott Reiber as an associate in the San Francisco office. Scott received his B.Comm. in International Business from the University of Alberta in 2003 and his J.D. from Columbia Law School in 2004. ■

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Deluxe Corp. v. California
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Dow Chemical Company v. Illinois
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Farmer Bros. v. California
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Hercules Inc. v. Kansas
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Hercules Inc. v. Minnesota
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