Amicus Letter to California Supreme Court Requesting Clarification of Rules for Determining Remedies in State Tax Cases

September 21, 2010

On September 21, 2010, Tax Executives Institute submitted the following "friend of the court" letter to the California Supreme Court in a case involving River Garden Retirement Home, urging the court to clarify the framework for crafting remedies when state tax provisions have been found unconstitutional. The letter was submitted under the aegis of TEI's State and Local Tax Committee, whose chair is Linda H. Dickens of Texas Instruments, Inc. Daniel B. De Jong, legal staff liaison to the State and Local Tax Committee, coordinated the preparation of the *amicus* letter.

On behalf of Tax Executives Institute, I write to urge the Court to grant the pending Petition for Review filed by River Garden Retirement Home in Supreme Court Case No. S185795. The case presents important constitutional and tax policy issues affecting Petitioner as well as other similarly situated taxpayers – namely, the proper remedy when a California tax statute is declared unconstitutional. The current state of the law is confusing and decisions by the various courts of appeal are irreconcilable. A decision by the Court would provide much needed clarity to taxpayers and the government affecting future decisions to challenge constitutionally suspect tax statutes.

Interest of the Applicant

Tax Executives Institute was founded in 1944 to serve the professional needs of business tax professionals. Today, the organization has 54 chapters in North America, Europe, and Asia, including several in California. Our 7,000 members represent 3,000 of the largest companies in the world, many of which are either resident or do business in California.

As the preeminent association of business tax professionals worldwide, TEI is dedicated to promoting the uniform and equitable enforcement of the tax laws, reducing the costs and burdens of administration and compliance to the benefit of both the government and taxpayers, and vindicating the Commerce Clause and other constitutional rights of all business taxpayers. As tax professionals who recognize the states' right to collect properly levied taxes and who respect the legitimacy of state assessments, TEI members have a significant interest in the standards applied in assessing the adequacy of remedies accorded taxpayers for unlawfully imposed and collected state taxes.

Why Review Should be Granted

A. Background

California provides a deduction in the computation of corporate taxable income for dividends received from corporations subject to tax in California. By its terms, the deduction does not apply to dividends received from subsidiaries with no operations in California.[1] In *Farmer Bros. Co. v. Franchise Tax Bd.*, the second district Court of Appeal found that the deduction violated the Commerce Clause of the U.S. Constitution since it discriminates against investments in subsidiaries with no California operations.[2] That court did not, however, determine the resulting remedy, leaving the issue unsettled (*i.e.*, is the deduction voided completely or do all dividends qualify for the deduction regardless of their source?).

Shortly after the *Farmer Bros.* decision, the Franchise Tax Board (FTB) issued a policy memorandum stating it would disallow all deductions claimed under the statute.[3] River Gardens challenged the FTB's policy, arguing that the statutory language limiting the deduction to dividends paid from companies taxable in California should be stricken and deductions should be allowed for all dividends. The court below denied River Garden's refund request and declared the deduction void in its entirety, stating that striking the constitutionally offensive language from the statute would constitute "judicial policymaking disguised as statutory reformation."[4]

B. The Need for Clarification

The decision of the court below added to a confusing array of statutes and court decisions on the issue of determining the appropriate remedy for California tax statutes found to be unconstitutional. For example, the Revenue and Taxation Code contains two contradictory sections in this area. Section 23057 requires that "[i]f any … clause, sentence or phrase of this part [the Corporation Tax Law] which is reasonably separable from the remaining portions of this part … is for any reason determined

unconstitutional, such determination shall not affect the remainder of this part" — which would provide relief to River Gardens and similarly situated taxpayers. Another provision, section 19393, provides that if a deduction, credit or exclusion violates the state or federal constitution "the tax of the favored taxpayer shall be recomputed by the Franchise Tax Board … by disallowing the deduction, credit, or exclusion…." The FTB relied on this section in its policy memorandum denying taxpayers deductions pursuant to the *Farmer Bros.* decision.

Varying interpretations of these standards by the Court of Appeal districts in California further muddle the area denying taxpayers and the government any predictability about the ultimate result of successfully challenging the constitutionality of a tax statute. TEI urges the court to hear this case to end the confusion surrounding the proper analytical framework for determining remedies and provide certainty essential to its application.

The Institute's members and the businesses by which they are employed have a vital interest in ensuring the sufficiency and predictability of remedies accorded taxpayers subjected to invalid state rules and regulations. Unless reversed, this case will affect far more than the state's authority to deny a deduction to River Gardens Retirement Home; it will inevitably have a deleterious effect on the analysis used by California courts in fashioning remedies in cases where state tax provisions have been found to violate the U.S. or California constitution.

If you have any questions about the Institute's views or desire additional information regarding the comments contained in this letter, please do not hesitate to contact Linda Dickens, Chair of TEI's State and Local Tax Committee, at 972.917.6912 (linda-dickens@ti.com) or Daniel B. De Jong of TEI's legal staff at 202.638.5601 (ddejong@tei.org).

1. The deduction applies to "[a] portion of the dividends received during the taxable year declared from income which has been included in the measure of the taxes imposed under Chapter 2 (commencing with Section 23101), Chapter 2.5 (commencing with Section 23400), or Chapter 3 (commencing with Section 23501) upon the taxpayer declaring the dividends." Cal. Rev. & Tax Code § 24402.
2. *Farmer Bros. Co. v. Franchise Tax Bd.*, 108 Cal. App. 4th 976 (2003).
3. Memorandum, California Franchise Tax Board, May 17, 2004.
4. *River Gardens Retirement Home v. Franchise Tax Bd.*, 186 Cal. App. 4th 922 (2010).
5. *See e.g., Abbott Laboratories v. Franchise Tax Bd.*, 175 Cal. App. 4th 1346 (2009); *Ventas Finance I LLC v. Franchise Tax Bd.*, 165 Cal. App. 4th 1207 (2008); *Macy's Dept. Stores, Inc. v. City & County of San Francisco*, 143 Cal. App. 4th 1444 (2006); *General Motors Corp. v. City & County of San Francisco,* 69 Cal. App. 4th 448 (1999); and *People's Fed. Sav. & Loan Assn. v. State Franchise Tax Bd.,* 110 Cal. App. 2d 696 (1952).

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ment the revisions to section 6041 were issued in May 2011, TEI recommends that the effective date be no earlier than for payments made on or after January 1, 2013, and the proposed transition period for soft B Notices and penalties end no earlier than for payments made through December 31, 2014.

23. The training burden to implement these requirements should not be underestimated because the effects of the expanded reporting burden are not limited to a company's accounts payable (AP) department. Companies often use wire transfers and ACH payments rather than issuing checks for large payments. These payments may be administered by corporate treasury or other finance employees outside of the AP department. Thus, far more personnel will have to be familiar with the reporting and backup withholding requirements as well as the need to solicit TINs/legal names and addresses, and W-9s.
24. Under Treas. Reg. § 1.274-5(c)(2)(iii), all travel and entertainment expenses (except for cab fares) in excess of $75 must be supported by documentary evidence. Many employers adopt the $75 threshold for all reimbursable expenses.
25. If the IRS agrees with TEI's recommended threshold, Treas. Reg. § 1.274-5(c)(2)(iii) should be conformed with it.
26. *See* Treas. Reg. § 31.3406(b)(3)-1(b)(3)(ii)(B).
27. The expanded section 6041 reporting requirements will also need to be coordinated with myriad reporting requirements for foreign persons.
28. Deferred purchase arrangements will be an additional source of mismatches between cash-basis, Form 1099 statements issued by payers and payee income tax returns, especially where a payer deposit or progress payment is not applied in the year paid. Specifically, contractual progress payments are often made against long-term purchase order commitments, especially for large-scale, made-to-order equipment. Unless a progress payment gives rise to a property or security interest or the payment is escrowed, the amounts may not be segregated by the vendor. By the time the deferred purchase closes, though, a substantial amount of the purchase price has likely been prepaid.
29. On the other hand, if the payer's system separates the amount, the payer should be permitted to report the separate amounts in addition to the gross payment.