

# California – In-state affiliates create nexus for financial securitization entities

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## In brief

A California superior court found that two corporations with no California physical presence had substantial nexus with California due to the activities of in-state agents. The corporations were established as bankruptcy remote special purpose entities (SPEs) and were engaged in securing loans for their parent and affiliated corporations that did business in California. The court found that the economic inter-dependence among the SPEs and their California affiliates created an agency relationship, which established nexus between California and the out-of-state SPEs. The court also found that the SPEs' securitization activities qualified them as financial corporations under California law. *[Harley-Davidson, Inc. v. California Franchise Tax Board, San Diego County Superior Court, No. 37-2011-00100846-CU-MC-CTL (5/1/13)]*

## In detail

### Facts

During 2000-2002, Harley-Davidson Financial Services (HDFS) originated loans in all states, including California, for the financing of motorcycles and accessories sold by Harley-Davidson, Inc. and its subsidiaries (collectively, Harley-Davidson). HDFS' California business activities included providing consulting services to third-party Harley-Davidson dealerships and offering training to dealerships on HDFS products. HDFS had two corporate subsidiaries created as special purpose entities (SPEs) to secure loans originated by HDFS. Another

subsidiary of HDFS, Harley-Davidson Credit Corporation (HDCC), controlled the activities and obligations of the SPEs. Once HDCC accepted a loan, it was deposited into an SPE trust. The loans were the only assets the SPEs held.

Typical financing and securitization transactions occurred as follows:

- HDFS approved retail loans.
- HDCC obtained and carefully scrutinized the loans for submission to the SPEs for bundling, securitization, and sale.
- Once HDCC accepted a loan for the SPEs, the loan was

deposited into an SPE trust. The SPEs only business was to purchase loans from HDCC and transfer them into trusts for securitization purposes.

- SPE trusts sold securities, backed by a pool of loans to underwriters. SPE provided liquidity to HDCC, which enabled HDCC to offer loans.
- After securitization, HDCC continued to service the loans.

HDCC exercised control over the SPEs by: (1) servicing the loans; (2) administering the SPE

trusts; (3) providing employees to control the SPEs' everyday activities (the SPEs had no employees of their own); (4) selling bundled loans owned by the SPE trusts to underwriters who would sell the securities in the open market; and (5) agreeing to indemnify the underwriters.

### ***Substantial nexus exists between the SPEs and California through their in-state agents***

The court recognized that, while owned by third parties, the Harley-Davidson dealerships were an integral part of Harley-Davidson and were the source of providing customers to HDFS for loans. A dealership was a “one-stop shop” to purchase and finance Harley-Davidson products. Based on these facts, the court found that Harley-Davidson and the dealerships were inter-dependent.

The court also found that HDFS, HDCC, and the SPEs enjoyed an “economic inter-dependence” for the following reasons:

- The SPEs provided liquidity to HDCC and HDFS, which enabled HDFS to offer loans.
- HDCC was responsible for the SPEs' core business functions by providing and managing the loans (that were bundled and securitized into notes and sold to investors).
- The SPEs depended on HDCC for their existence. The SPEs conducted business only on behalf of HDFS. Furthermore, their Articles of Incorporation precluded them from doing anything other than securitizing HDCC loans without board and stockholder approval.

- The SPEs were not doing business for themselves, but rather for HDFS. The SPEs could not be considered independent contractors because HDFS had a right to exercise control over the SPEs and the SPEs only did business for HDFS.

Accordingly, the court held that the SPEs had substantial nexus with California through their in-state agents, HDFS, HDCC, and the dealerships.

### ***Existence as bankruptcy remote subsidiaries was irrelevant***

Harley-Davidson argued that the SPEs were established as bankruptcy remote subsidiaries, which allowed the assets and liabilities of the SPEs to be excluded from Harley-Davidson's consolidated financial statements. The court found that the SPEs' status as bankruptcy remote subsidiaries was not relevant to the determination of whether they had nexus with California.

### ***The SPEs were financial corporations***

California defines a financial corporation as one that predominantly deals in “money or moneyed capital in substantial competition with the business of national banks.” Harley-Davidson argued that the SPEs were not in substantial competition the national banks. However, the court found that during the years at issue national banks bundled loans and sold securities backed by such loans (asset-backed securities). Accordingly, given that likely all of the SPE's income came from the sale of asset-backed securities, the court found that the

SPEs satisfied the requirement for financial corporations to be in substantial competition with national banks.

### ***The takeaway***

This case originally contained two additional issues: (1) whether section 25101.15 gives rise to discrimination as it provides intrastate unitary businesses the option to file a return based on a unitary combined report, whereas *interstate unitary businesses are required* to file a return on a unitary combined report and (2) whether Harley-Davidson had the ability to elect the equally-weighted three factor apportionment formula (the Multistate Tax Compact election or *Gillette* issue). In March 2012, on demurrer, the California Superior Court held in favor the Franchise Tax Board with respect to these two issues.

This left the remaining issues of whether California had nexus sufficient to justify taxation of the SPEs, and if so, whether the factors of these subsidiaries could be used to apportion income to California. There are few cases that discuss agency nexus or the issue of what activities constitute financial activity. While decisions by the California Superior Court are not precedential, they are often instructive regarding the FTB's perspective on certain matters. With respect to these issues as well as the issues decided on demurrer, Harley-Davidson has filed a notice of intent to file a motion for a new trial. We will continue to monitor developments in this case and report on any significant developments.

## **Let's talk**

If you have questions regarding the *Harley-Davidson* decision, please contact:

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