California - Allowing intrastate unitary businesses to elect combined reporting is facially discriminatory, lower court to determine constitutionality

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In brief

On May 28, 2015, a California Court of Appeals found a California tax scheme that allows only intrastate unitary taxpayers to make a separate or combined filing election was facially discriminatory. The court remanded the case back to the trial court to determine whether the scheme advances a legitimate local purpose that cannot be adequately served by reasonable nondiscriminatory alternatives.

The court also made a nexus finding regarding two of that taxpayer's subsidiaries. The court's determination regarding this issue will be addressed in a separate Insight.

[*Harley-Davidson, Inc. v. Franchise Tax Board*, Cal. App. Ct.., No D064241 (5/28/15)]

In detail

Background – California's election for intrastate unitary businesses

California allows intrastate unitary taxpayers to elect annually whether to compute their tax using combined or separate company reporting. However, California requires taxpayers engaged in a unitary business within and without California (interstate taxpayers) to use the combined reporting method.

Facts and procedural history

Harley engages in two lines of business - a motorcycle business and a financial services business. During the tax years at issue, Harley took the position that its two lines of business were not unitary and, as a result, it did not include its financial services business information on its California tax return.

Following an audit, the California FTB determined that Harley's businesses were unitary and that Harley was required to include the information and income of the financial services business in its California return. Harley paid the assessment and sued the Franchise Tax Board (FTB) in a California superior court for a refund.

At the superior court, Harley asserted that California's tax scheme, which allows intrastate unitary taxpayers, but not interstate unitary taxpayers, to elect to file on a combined or separate basis, was discriminatory. The FTB demurred to Harley's complaint.

The trial court sustained the demurrer. Harley appealed the trial court's decision to a California Court of Appeal.

Dormant Commerce Clause challenge

The court provided that a dormant Commerce Clause challenge requires a determination of whether:

1. the relevant aspects of California's tax scheme treat intrastate and interstate unitary businesses differently
2. any differential treatment discriminates against interstate commerce either by benefiting intrastate business or burdening interstate businesses
3. any discriminatory differential treatment withstands strict scrutiny.

California's statutory scheme is facially discriminatory

The FTB effectively conceded that California's tax scheme treated intrastate and interstate business differently. Thus, the court's analysis focused on whether this differential treatment was discriminatory.

The court considered the following examples of state tax schemes that have been determined by other courts (both federal and state) to discriminate against interstate commerce:

- Allowing a deduction from a state's intangible tax equal to the fraction of the issuing corporation's income in the state. *Fulton Corp. v. Faulkner*, 516 U.S. 325 (1996).
- Giving domestic corporations the ability to reduce their franchise tax liability by reducing the par value of their stock, while denying foreign corporations the same ability. *South Central Bell Telephone Co. v. Alabama,* 526 U.S. 160 (1999).
- Allowing in-state taxpayers to defer capital gains on the sale of stock in a qualified small business if the taxpayer used the gain to purchase stock in another qualified small business that used at least 80 percent of its assets and 80 percent of its payroll to conduct business within the home state. *Cutler v. Franchise Tax Board*, 208 Cal. App. 4th 1247 (Cal. App. Ct. 2012).
- Providing a corporate tax deduction for dividends paid to the corporation from the corporation's insurance subsidiaries but only if the dividends paid were from income from in-state sources. *Ceridian Corp. v. Franchise Tax Board*, 85 Cal. App. 4th (Cal. App. Ct. 2000).
- Providing a deduction for a portion of the dividends received from subsidiaries doing business and subject to tax in California. *Farmer Bros. Co. v. Franchise Tax Board,* 108 Cal. App. 4th 976 (Cal. App. Ct. 2003).
- Allowing an affiliate group to file on a consolidated basis only if 50 percent or more of the group's income was derived from in-state sources. *General Motors Corp. v. Director of Revenue*, 981 S.W.2d 561 (Mo. 1998).

The court's reading of the above examples led to the 'unavoidable conclusion' that California's tax scheme facially discriminates on the basis of an interstate element in violation of the Commerce Clause. The court explained, "whether a unitary business computes its California tax liability using the separate accounting method or the combined reporting method is determined solely by where the unitary business engages in commerce."

The court stated that the FTB failed to "cite any authority that would support the proposition that the Commerce Clause can only invalidate a single statute or deduction and not 'California's entire *tax scheme* of requiring multistate unitary businesses to use combined reports.'"

Benefits and burdens of the election

The FTB argued that any differential treatment is not discriminatory because it neither benefits intrastate businesses nor burdens interstate ones. The court rejected this argument because Harley's complaint alleges the existence of such benefits and burdens, including the ability to more efficiently use credits and net operating losses, a reduced tax burden, increased administrative ease, and lower compliance costs in preparing returns. The court accepted such allegations as true in the context of reviewing an order sustaining a demurrer.

Remanded to lower court to determine if legitimate reason to impose discriminatory treatment exists

The court acknowledged that a discriminatory restriction of commerce is virtually per se invalid unless the justifications for discriminatory restrictions on commerce pass the strictest scrutiny. Accordingly, a discriminatory restriction must be invalided unless its proponent can show that it advances a legitimate local purpose that cannot be adequately served by reasonable nondiscriminatory alternatives.

Finding that California's tax scheme was facially discriminatory, the court considered whether it could pass strict scrutiny. The FTB argued that the scheme could pass the strict scrutiny standard because allowing multistate unitary businesses to file on a separate basis would allow taxpayers to manipulate their California income. Such manipulation would not accurately reflect their in-state income and could deprive California of much needed revenue.

The court noted that the record was undeveloped on this issue because the issue was being raised for the first time on appeal and because the appeal arose from an order sustaining a demurrer. The record was undeveloped with respect to (1) whether the FTB identified a legitimate reason for differentiating between and discriminating against intrastate and interstate unitary businesses and, if so, (2) whether that legitimate reason can be adequately served by reasonable nondiscriminatory alternative. Accordingly, the court remanded the case back to the trial court to determine whether California's scheme is able to withstand strict scrutiny.

The takeaway

Although the court determined that California's statutory scheme is facially invalid, the case is not yet over. On remand, the trial court will consider whether the election advances a legitimate local purpose that cannot be adequately served by reasonable nondiscriminatory alternatives.

It remains unclear how the recent US Supreme Court decision in *Wynne* (click here for our summary), and the opinion's absence of a strict scrutiny analysis, impacts the court's decision here.

Let's talk

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