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In this installment of A Pinch of SALT, Gustafson and Kaur examine two 2023 decisions, *Appeal of Minnesota Beet* and *American Catalog Mailers Association*, that may affect current informal guidance and the issuance of guidance in 2024.

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The California Franchise Tax Board administers the state's corporate franchise and income taxes.¹ For it to complete this task, the California Legislature authorized the FTB to promulgate regulations in order to implement and interpret the governing statutes.² Beyond issuing formal guidance, however, the FTB historically, and routinely, has issued informal guidance on a broad array of topics and issues for the purported benefit of taxpayers, tax practitioners, and FTB staff alike.

While taxpayers and tax practitioners have disagreed with certain conclusions presented in the FTB's informal guidance over the years, the materials by and large have provided valuable insight into the agency's varied positions and interpretations, particularly for taxpayer reporting purposes. Regarding the points of disagreement, a question until recently remained as to what effect, if any, was to be given to the

FTB's informal guidance by a tribunal adjudicating a corporate tax controversy matter.

Two 2023 decisions offered differing answers to this question that may affect current informal guidance and the issuance of guidance in 2024 and beyond.

First, the California Office of Tax Appeals (OTA) rejected the FTB's 17-year-old litigating position as reflected in a legal ruling on the issue of whether apportionment factors related to deductible income are includable in a combined report in *Appeal of Southern Minnesota Beet Sugar Cooperative and Subsidiary*.³ Second, and perhaps more consequentially, the San Francisco Superior Court ruled an FTB technical advice memorandum and a publication interpreting and applying Public Law 86-272 — a federal statute prohibiting a state from imposing a tax on the net income of a multistate taxpayer if that taxpayer's activities in the jurisdiction are limited to the solicitation of sales of tangible personal property⁴ — invalid as underground regulations in *American Catalog Mailers Association (ACMA)*.⁵

This article, after briefly identifying the myriad types of informal guidance issued by the FTB, examines the two decisions more closely and identifies their potential fallout.

The Many Faces of the FTB's Informal Guidance

For decades, the FTB has issued informal guidance on innumerable topics. The primary stated purpose of this guidance has been to inform the broader California tax community, including the FTB's own audit staff, of the agency's

¹The FTB also administers California's personal income tax, but this article focuses primarily on corporate taxes for the sake of brevity.

²See, e.g., Cal. Rev. & Tax. Code sections 25135 and 25136 (authorizing the FTB to "prescribe regulations as necessary or appropriate to carry out the purposes" of California's statutory sales factor sourcing provisions).

³*Appeal of Southern Minnesota Beet Sugar Cooperative and Subsidiary*, 2023-OTA-342P (Cal. Tax App. Mar. 17, 2023).

⁴See 15 U.S.C. sections 381-384.

⁵*American Catalog Mailers Association v. Franchise Tax Board*, No. CGC-22-601363 (Cal. Super. Ct. Dec. 13, 2023).

interpretations and applications of tax statutes, regulations, judicial and administrative decisions, and on other tax issues. This guidance has come in response to taxpayer-specific questions, audit staff technical questions, court cases, administrative appellate decisions issued by the California State Board of Equalization and the OTA, and common or recurring issues identified by the FTB Legal Division, among others.

The informal guidance takes many forms, including:

- **Legal Rulings:** Published interpretations of existing tax law by the FTB's chief counsel. Each ruling sets forth a conclusion regarding how the law applies to a set of hypothetical facts and is issued for the guidance of taxpayers and tax practitioners, FTB staff, and other interested parties. The FTB often relies on its legal rulings in controversy matters and argues that the rulings are entitled to deference.
- **Chief Counsel Rulings:** Formal responses to taxpayer requests by the FTB's chief counsel regarding the application of existing tax law to a specific set of facts. While the requesting taxpayer may rely on the ruling for purposes of avoiding tax, interest, or penalties related to the underlying issue therein,⁶ the FTB characterizes the published rulings as "informational only" for other taxpayers and asserts that the rulings "may not be used or cited as precedent."
- **Technical Advice Memorandums:** Responses by the FTB's Legal Division to FTB staff requests regarding the interpretation of existing tax law or the application of existing tax law to a specific set of facts. The advice contained in a technical advice memorandum is for informational purposes only and, like published chief counsel rulings, is not citable precedent.
- **FTB Notices:** Written statements discussing procedural issues arising from a statute or regulation or providing

information related to a change in law, recent case developments, well-established principles, or other matters of general public interest.

In addition, the FTB issues publications, which primarily serve as guidelines for return preparation. These publications can address legal concepts and the application of those concepts to taxpayers in the context of a corporate return.⁷ The FTB also publishes copies of its own internal procedural manuals that are intended to aid FTB audit staff in the performance of various kinds of audits or in addressing specific audit issues.⁸ These manuals are replete with the FTB's interpretations and application of the tax law in effect at the time the particular manual was last updated.⁹

OTA's Rejection of Legal Ruling 2006-01

In *Appeal of Minnesota Beet*, the OTA refused to defer to the FTB's conclusions on the interpretation of California's apportionment statutes as articulated in a long-standing FTB legal ruling. The Minnesota-based taxpayer had historically operated as a not-for-profit agricultural cooperative that manufactured sugar and sugar byproducts from sugar beets.¹⁰ The taxpayer ultimately acquired a California-based for-profit general corporation that also manufactured sugar and other products from sugar beets.¹¹

After the acquisition, the taxpayer filed a combined report in California for both the not-for-profit cooperative and the for-profit general corporation.¹² On its California returns, the taxpayer included the income of the for-profit general corporation in the tax base while

⁷ See, e.g., FTB Publication 1061, "2022 Guidelines for Corporations Filing a Combined Report" (last accessed Jan. 2, 2024) (setting forth "the concepts of the unitary method of taxation and its application by the State of California to corporations subject to either the franchise tax or income tax").

⁸ See FTB, "FTB Procedures," and the manuals linked to therein (last accessed Jan. 2, 2024).

⁹ For example, the FTB's Multistate Audit Technique Manual "contains discussions of statutes, regulations, court decisions, department policies, and audit techniques." Multistate Audit Technique Manual, section 0100 (rev. Aug. 2019).

¹⁰ *Appeal of Minnesota Beet*, 2023-OTA-342P, at 2 (Cal. Tax App. Mar. 17, 2023).

¹¹ *Id.*

¹² *Id.* at 3.

⁶ See Cal. Rev. & Tax. Code section 21012(a)(1).

deducting the entirety of the cooperative member's income under Cal. Rev. & Tax. Code section 24404.¹³ In determining the combined group's California apportionment percentage, though, the taxpayer included not only the property, payroll, and sales attributable to the operations of the for-profit general corporation but also the property, payroll, and sales attributable to the deductible income of the cooperative members.¹⁴

At audit, the FTB adjusted the taxpayer's apportionment factors to exclude the property, payroll, and sales giving rise to income deducted on the return — that is, the out-of-state cooperative's factors.¹⁵ The FTB based its adjustment on the rationale expressed in Legal Ruling 2006-01¹⁶ — namely, that factors related to income amounts not included in income subject to apportionment must likewise be excluded, whether the underlying income is “‘exempted,’ ‘excluded,’ ‘deducted,’ [‘] ‘not recognized,’ etc.”¹⁷ The adjustment resulted in a significant increase in the taxpayer's California apportionment percentage, as only the California-based manufacturer's factors remained, thereby increasing the taxpayer's California tax liability.¹⁸ Consequently, the FTB issued a proposed assessment.¹⁹ The taxpayer protested the proposed assessment, and then appealed to the OTA after the proposed assessment was finalized.²⁰

On appeal, the FTB argued that the OTA should “defer to [the FTB's] Legal Ruling 2006-01 . . . which has set forth its position for the past 17 years.”²¹ The OTA, however, objected to the

application of the FTB's ruling in the specific context of factors related to income deductible under Cal. Rev. & Tax. Code section 24404. First, using a plain language analysis, the OTA concluded that nothing in the statutory apportionment provisions or the accompanying regulations “provides that the factors used to generate deductible member income under [Cal. Rev. & Tax. Code section] 24404 are excluded from the apportionment formula.”²² Going further, the OTA found that the statutory apportionment provisions do not contain “any general exclusion of activities that produce deductible income” in determining the property, payroll, or sales factor.²³

Second, the OTA highlighted how Legal Ruling 2006-01 did not “squarely address deductible member income under [Cal. Rev. & Tax. Code section] 24404,” and instead too broadly equated deducted income with “exempted,” “excluded,” or otherwise “not recognized” income.²⁴ Challenging the ruling's language, the OTA noted how, unlike the latter, income deductible under section 24404 is “first considered gross income and then deducted . . . to determine net income subject to tax.”²⁵ Despite the FTB's call for absolute deference, the OTA ultimately applied “its own independent judgment” in reversing the adjustment, while acknowledging the “FTB's expertise in multistate taxation” and giving “careful consideration to FTB's position.”²⁶

San Francisco Trial Court's Invalidation Of TAM 2022-01 and Pub. 1050

Whereas the OTA merely considered the level of deference to be afforded to the FTB's informal guidance in *Appeal of Minnesota Beet*, the San Francisco Superior Court more recently

¹³ *Id.* Cal. Rev. & Tax. Code section 24404 permits agricultural cooperatives to deduct “all income resulting from or arising out of such business activities for or with their members carried on by them or their agents; or when done on a nonprofit basis for or with nonmembers.”

¹⁴ *Appeal of Minnesota Beet*, 2023-OTA-342P, at 4. During the years at issue in the case — the taxpayer's fiscal years ending August 31, 2009, through August 31, 2012 — California's standard apportionment formula consisted of a property factor, a payroll factor, and a double-weighted sales factor. *See* Cal. Rev. & Tax. Code section 25128(a).

¹⁵ *Appeal of Minnesota Beet*, 2023-OTA-342P, at 4.

¹⁶ *Id.*

¹⁷ FTB Legal Ruling 2006-01, at 5, n.4 (Apr. 28, 2006).

¹⁸ *Appeal of Minnesota Beet*, 2023-OTA-342P, at 5.

¹⁹ *Id.*

²⁰ *Id.*

²¹ *Id.* at 16.

²² *Id.* at 9-10. California enacted its own version of the Uniform Division of Income for Tax Purposes Act whereby multistate taxpayers allocate and apportion net income to the state. *See* Cal. Rev. & Tax. Code sections 25120-25141. “Many of FTB's regulations under the UDITPA are based on the Multistate Tax Commission's model regulations interpreting the UDITPA.” *Appeal of Minnesota Beet*, 2023-OTA-342P, at 9, n.14 (citation omitted); *see also* Cal. Code Regs. tit. 18, sections 25120-25139.

²³ *Appeal of Minnesota Beet*, 2023-OTA-342P, at 10.

²⁴ *Id.* at 18.

²⁵ *Id.* at 19.

²⁶ *Id.* at 21.

invalidated informal FTB guidance entirely in *ACMA*.

The guidance at issue in that case was TAM 2022-01 and Publication 1050. Both set forth the FTB's intended application of P.L. 86-272 to activities conducted via the internet through the inclusion of various hypothetical fact patterns describing activities that the FTB considered either protected or unprotected under federal law.²⁷ The American Catalog Mailers Association (*ACMA*) — a trade association representing out-of-state catalog, online, direct mail, and other remote-selling merchants — brought suit in a California trial court seeking a declaratory judgment that TAM 2022-01 and Pub. 1050 were invalid as inconsistent with P.L. 86-272 and the U.S. Constitution, or as underground regulations that the FTB failed to promulgate in accordance with California's Administrative Procedure Act.²⁸ In particular, *ACMA* objected to scenarios in the guidance involving a company's use of internet cookies and post-sale online support activity.²⁹

After filing its action, *ACMA* brought a motion for summary adjudication on its first cause of action — namely, that the guidance was invalid as inconsistent with federal law.³⁰ While noting that the FTB's guidance raises “significant concerns as to the FTB's interpretation and application of P.L. 86-272,” the court denied the motion because it could not “conclude as a matter of law that the use of generic hypotheticals in [TAM 2022-01] and Publication 1050 contradict P.L. 86-272 on their face such that” the guidance in its entirety is invalid.³¹

ACMA then brought a motion for summary adjudication on its second cause of action — that both TAM 2022-01 and Pub. 1050 were de facto, or underground, regulations, and thus invalid because the FTB did not promulgate them under the procedures set forth in California's APA.³² The court granted this motion.³³ Applying a two-part test set forth by the California Supreme Court for determining whether a particular rule meets the APA's broad definition of a regulation,³⁴ the trial court concluded that the guidance constituted underground regulations because both the TAM and the publication (1) “articulate[d] general rules that declare how a certain class of cases will be decided” and (2) “interpret[ed] the FTB's application of P.L. 86-272 to out-of-state businesses.”³⁵ Based on this conclusion, and the FTB's concession that neither TAM 2022-01 nor Pub. 1050 were “enacted as regulations in compliance with the APA,” the court ruled the guidance void.³⁶

The Fate of the FTB's Informal Guidance in 2024

From a taxpayer perspective, *Appeal of Minnesota Beet* is an encouraging decision. Instead of blindly deferring to the FTB's stated position on the exclusion of activities related to deductible income from the apportionment factor, or otherwise rubber-stamping the FTB's assessment, the OTA acknowledged the FTB's “extensive expertise in the complex area of multistate taxation,”³⁷ highlighted how the FTB's interpretation had not “been formally adopted in regulations,”³⁸ and proceeded to apply its own

²⁷ See FTB TAM 2022-01 (Feb. 14, 2022) (last accessed Jan. 4, 2024); see also FTB Publication 1050, “Application and Interpretation of Public Law 86-272” (rev. May 2022) (last accessed Jan. 4, 2024).

²⁸ *ACMA*, No. CGC-22-601363, at 2. These causes of action were brought under Cal. Gov't Code section 11350, which allows for judicial review of the validity of a regulation. *ACMA* also challenged the validity of the guidance under Cal. Civ. Proc. Code section 1060, which allows for a declaration as to an interested person's rights concerning another.

²⁹ Both TAM 2022-01 and Pub. 1050 contain a hypothetical scenario involving a business that “places Internet ‘cookies’ onto the computers or other electronic devices of California customers” that “gather customer search information that will be used to adjust production schedules and inventory amounts, develop new products, or identify new items to offer for sale.” TAM 2022-01, at 2; see also Pub. 1050, at 4. Both also contain a hypothetical scenario involving a business that “regularly provides post-sale assistance to California customers via either electronic chat or email that customers initiate by clicking on an icon on the business's website.” TAM 2022-01, at 1; see also Pub. 1050, at 4.

³⁰ *ACMA*, No. CGC-22-601363, at 3.

³¹ *Id.* at 26 (Cal. Super. Ct. Aug. 24, 2023).

³² *Id.* at 4.

³³ *Id.* at 12.

³⁴ Under the APA, a “regulation” includes “every rule, regulation, order, or standard of general application or the amendment, supplement, or revision of any rule, regulation, order, or standard adopted by any state agency to implement, interpret, or make specific the law enforced or administered by it, or govern its procedure.” Cal. Gov't Code section 11342.600.

³⁵ *ACMA*, No. CGC-22-601363, at 7-8; see also *Tidewater Marine Western Inc. v. Bradshaw*, 14 Cal. 4th 557, 571 (1996) (describing the “two principal identifying characteristics” of a regulation as “first, the agency must intend its rule to apply generally, rather than in a specific case,” and “second, the rule must implement, interpret, or make specific the law enforced or administered by [the agency], or . . . govern [the agency's] procedure”) (internal quotations and citations omitted).

³⁶ *ACMA*, No. CGC-22-601363, at 3, 11.

³⁷ *Appeal of Minnesota Beet*, 2023-OTA-342P, at 15-16.

³⁸ *Id.* at 16.

independent judgment based on the governing statutes, regulations, and case law.³⁹ In this way, the OTA approached the FTB's informal guidance the same way that California courts have.⁴⁰ The decision serves as a reminder that while the FTB may have "extensive expertise" in corporate taxation, its positions are subject to challenge. An adjudicative body, whether the OTA or a court, ultimately should consider the relative strength of those positions — particularly informal positions — in light of the governing law.

ACMA, in comparison, is potentially troubling. Unlike the OTA in *Appeal of Minnesota Beet*, the court did not address the merits of the FTB's position expressed in TAM 2022-01 and Pub. 1050. Instead, the court struck the informal guidance as void.⁴¹ "'Void' in this context does not necessarily mean wrong," however.⁴² Indeed, the FTB recently filed a motion to vacate and modify the judgment to clarify this very point.⁴³ The ruling notwithstanding, the question whether the presence of internet cookies or certain post-sale online activities transgresses the limited protections of P.L. 86-272 remains open. In other words, even without its guidance to point to, the FTB will make the same arguments on the merits, and a court will need to rule.

While the court's order suggests that the practical consequence of its ruling is that the guidance in question is "not entitled to any deference,"⁴⁴ the ruling may in fact breed a slew of

similar challenges to the FTB's informal guidance in its various forms. Again, many legal rulings, TAMs, and other publications include the FTB's stated interpretation of corporate tax statutes, regulations, and decisions, despite not being promulgated in accordance with California's APA. Further, the decision may produce a chilling effect on the FTB's issuance of informal guidance if the alternative is to have to go through the time-consuming and resource-intensive formal regulation process. Such an effect would be cause for concern. Agree with the FTB or not, its abundant guidance is often invaluable to taxpayers when filing annual corporate tax returns. Knowing the FTB's position on a given issue, coupled with the stubborn persistence of California's pernicious large corporate understatement penalty, can affect how a taxpayer reports that issue.

On the other hand, the APA is a critical bulwark against agency overreach. A key aspect of the process is that it affords taxpayers, practitioners, and other interested parties an opportunity to voice competing views on a given issue and requires the FTB to consider those views before formalizing guidance in a regulation. Even if the FTB ultimately disagrees with those views, the process itself serves an important function through the notice and participation requirements and justifies the distinction in legal effect between a regulation and other informal guidance. If nothing else, ACMA should give the FTB pause before it attempts to place undue weight on its own informal guidance at any point in the tax controversy lifecycle.

As we head into 2024, we will continue to watch this case. And we will watch how it affects the FTB's practice of issuing informal guidance, if at all. ■

³⁹ *Id.* at 21.

⁴⁰ See, e.g., *McDonnell Douglas Corp. v. Franchise Tax Board*, 26 Cal. App. 4th 1789, 1796 (Cal. Ct. App. 1994) (referring to legal rulings as "simply administrative opinions," the California Court of Appeal held that the FTB's place of delivery rule for sourcing sales of tangible personal property as set forth in regulations and informal guidance was contrary to the intent of the governing statutory scheme); see also *Swart Enterprises Inc. v. Franchise Tax Board*, 7 Cal. App. 5th 497, 500 (Cal. Ct. App. 2017) (disagreeing with the analysis and conclusion in FTB Legal Ruling 2014-01 regarding whether "a member of a manager-managed LLC is doing business in California provided the LLC is itself doing business in California").

⁴¹ ACMA, No. CGC-22-601363, at 11.

⁴² *Alvarado v. Dart Container Corp. of California*, 4 Cal. 5th 542, 556 (2018).

⁴³ ACMA, No. CGC-22-601363, "Defendant Franchise Tax Board's Notice of Motion to Vacate and Modify Judgment" (Dec. 27, 2023). On December 18, 2023, the court entered a judgment — which had been prepared by ACMA — stating that the guidance was "void and without force or effect, and . . . may not be relied upon." The FTB's motion challenges the addition of the language after "void" as inconsistent with the court's December 13, 2023, order and a misstatement of the law.

⁴⁴ ACMA, No. CGC-22-601363, at 12 (quoting *Alvarado*, 4 Cal. 5th at 556 (internal quotations and citation omitted)).