

Good Riddance? FTB's Informal Guidance Is Literally Disappearing

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In this installment of A Pinch of SALT, Friedman and Gustafson discuss the seeming disappearance of the California Franchise Tax Board's informal guidance.

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One year ago, the San Francisco County Superior Court invalidated two pieces of informal guidance issued by the California Franchise Tax Board as "underground regulations" in *American Catalog Mailers Association (ACMA)*.¹ The court held that FTB TAM 2022-01 and FTB Publication 1050, both of which analyzed the impact of an out-

of-state corporation's internet activities on protections afforded under P.L. 86-272,² were rules of general applicability.³ Consequently, the court concluded, the technical advice memorandum and publication constituted "regulations" subject to California's Administrative Procedure Act,⁴ and because they were not enacted in compliance with the APA they were void.⁵

Notably, the FTB did not appeal the trial court's decision, and the taxpayer and practitioner communities alike were left wondering what would become of the FTB's other technical advice memoranda, as well as the rest of its veritable treasure trove of informal administrative guidance. At the time of the decision, the FTB had on its website a compendium of informal rulings, memoranda, and notices, along with various publications and return instructions, all of which arguably interpreted various aspects of California's statutory corporate tax provisions, and potentially constituted rules of general applicability.⁶ Not anymore.

Midway through 2024, and without any notice, the FTB pulled all technical advice memoranda from its website. Overnight, decades of responses by the FTB's Legal Division to FTB staff requests regarding the interpretation of

² See 15 U.S.C. sections 381-384.

³ *ACMA*, Case No. CGC-22-601363, at 7-8.

⁴ See Cal. Gov't Code section 11340 et seq.

⁵ *ACMA*, Case No. CGC-22-601363, at 3, 11.

⁶ For a detailed discussion of the types of informal guidance issued by the FTB and the impact of the guidance in recent California tax controversy cases, including *ACMA*, see Timothy A. Gustafson and Gursharan Kaur, "Is California FTB's Informal Guidance at a Crossroads?" *Tax Notes State*, Feb. 12, 2024, p. 483.

¹ *American Catalog Mailers Association v. Franchise Tax Board*, Case No. CGC-22-601363 (Cal. Super. Ct. San Francisco Cnty., Dec. 13, 2023).

existing tax law or the application of existing tax law to a specific set of facts literally disappeared.⁷

While the bulk of the FTB's informal guidance remains available to the public,⁸ the question becomes, for how long? Will FTB notices and legal rulings, found alongside its active regulation projects and formal regulations on a landing page titled "Law," suffer the same fate as the technical advice memoranda? A more provocative question may be, should they? California's APA provides the necessary context for answering these questions.

California's APA

"The APA subjects proposed agency regulations to certain procedural requirements as a condition to their becoming effective."⁹ As such, it serves as a critical bulwark against agency overreach by "direct[ing] the attention of agency policymakers to the public they serve" and "thus providing some security against bureaucratic tyranny."¹⁰

Before adopting a regulation, an agency must give public notice,¹¹ issue a complete text,¹² issue a statement of reasons for the proposed regulation,¹³ provide an opportunity for public comment,¹⁴ respond in writing to all public comments,¹⁵ and forward a file of all materials relied on by the agency to the Office of Administrative Law (OAL).¹⁶ The OAL, in turn, "reviews the regulation for consistency with the law, clarity, and necessity."¹⁷ Any regulation "that substantially fails to comply with these

requirements may be judicially declared invalid."¹⁸

The APA defines a "regulation" as "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 to govern its procedure."¹⁹ Interpreting this broad definition, courts have identified the "two principal . . . characteristics" of a regulation as: (1) "the agency must intend its rule to apply generally, rather than in a specific case" and (2) "the rule must implement, interpret, or make specific the law enforced or administered by [the agency], or . . . govern [the agency's] procedure."²⁰

The FTB and the APA

The FTB, for its part, follows the APA in promulgating formal regulations and regulatory amendments. To its credit, the FTB also regularly engages in an informal process before initiating formal proceedings under the APA.²¹ This informal process typically involves hosting interested parties meetings, soliciting and responding to public comment, and publishing multiple iterations of proposed draft language for public review.

The FTB's goals in implementing this informal procedure, including transparency, maximum public participation, and a streamlined formal rulemaking process, are admirable. However, at times these informal procedures lead to confusion, disparate treatment, and seemingly unending delay. Consider, for example, the FTB's ongoing project to amend its market-sourcing regulation.

⁷ While technical advice memoranda have been removed from the FTB's website, they remain available on various research databases.

⁸ See, e.g., FTB, "Law" (accessed Jan. 2, 2025).

⁹ *Morning Star Co. v. State Board of Equalization*, 38 Cal. 4th 324, 332 (Cal. 2006).

¹⁰ *Tidewater Marine Western Inc. v. Bradshaw*, 14 Cal. 4th 557, 568-569 (Cal. 1996) (citation omitted).

¹¹ Cal. Gov't Code sections 11346.4 and 11346.5.

¹² Cal. Gov't Code section 11346.2(a).

¹³ Cal. Gov't Code section 11346.2(b).

¹⁴ Cal. Gov't Code section 11346.8.

¹⁵ Cal. Gov't Code sections 11346.8(a) and 11346.9.

¹⁶ Cal. Gov't Code section 11347.3(b).

¹⁷ *California Advocates for Nursing Home Reform v. Bontá*, 106 Cal. App. 4th 498, 507 (Cal. Ct. App. 2003) (citing Cal. Gov't Code sections 11349.1 and 11349.3).

¹⁸ *Id.* (citing Cal. Gov't Code section 11350).

¹⁹ Cal. Gov't Code section 11342.600 (emphasis added).

²⁰ *Tidewater*, 14 Cal. 4th at 571 (internal quotations and citations omitted).

²¹ The FTB's current regulation projects can be found on its website under "Active Regulation Projects" (accessed Jan. 2, 2025).

California introduced market-based sourcing in 2011²² and implemented it as the standard rule for corporate taxpayers in 2013.²³ The FTB promulgated its market-sourcing regulation in 2011²⁴ and began an informal process in late 2016 to provide guidance through an amendment. It held six interested parties meetings over the next five years, and published at least five iterations of draft amendments to the regulation before receiving formal approval by its three-member governing board to begin the formal process in September 2021 — 10 years after adopting market-based sourcing.²⁵ Amid the uncertainty of ever-changing drafts, many taxpayers found themselves in a state of limbo while trying to calculate the sales factor on their returns. Taxpayers found auditors either ignoring the draft provisions, anticipating the promulgation of a particular new iteration, or delaying review for as long as possible to allow for the process to finish. And after three years, the FTB finally initiated the formal regulatory amendment process in September 2024. To top it off, with a public hearing finally set eight years after the project began, issues with the proposed language remain unresolved.

In light of the above, it would no doubt be tempting for the FTB to simply issue a legal ruling interpreting the regulation as currently in effect. And that is exactly what the FTB did.

In March 2022, after concluding the informal regulation amendment process but before starting the formal process under the APA, the FTB issued Legal Ruling 2022-01 to address the sourcing of receipts from the sale of services.²⁶ The ruling sets forth the FTB's position regarding the "relevant considerations and proper analysis" for sourcing sales of services, poses four questions as

"guidelines" to assist in the sourcing analysis,²⁷ and walks through four scenarios whereby the FTB interprets and applies its regulation. FTB staff frequently rely on Legal Ruling 2022-01 at audit and protest.²⁸

For FTB auditors to rely on the agency's informal guidance is one thing. For taxpayers, the Office of Tax Appeals (OTA), or courts to rely on — let alone defer to — such guidance is another.

Informal Guidance or Underground Regulations?

The problem is not the guidance itself, per se. The FTB administers the state's corporate franchise and income taxes,²⁹ and so must interpret the relevant law. Neither is its publication. Knowing the FTB's interpretation and related positions has been, and continues to be, invaluable to taxpayer and practitioner communities. While we may disagree, we can at least make informed decisions when filing returns or deciding whether to challenge an assessment or refund claim denial. Otherwise, we are sailing without a map.

The problem is the imprimatur of binding authority. The FTB, for example, routinely cites its "informal" legal rulings as authoritative in controversy matters, whether at audit, on appeal, or beyond. According to the FTB, the OTA, "as well as the California court system, may consider and attribute some weight to legal rulings in their decisions."³⁰ Indeed, California courts have considered, and relied on, FTB legal rulings.³¹ The FTB has even issued a legal ruling *during litigation*

²²For tax years 2011 and 2012, multistate corporate taxpayers had an option to elect single-sales-factor apportionment instead of using the standard three-factor formula with a double-weighted sales factor (Cal. Rev. & Tax. Code section 25128.5 (2012)). Taxpayers making the election were required to use market-based sourcing to calculate the sales factor (Cal. Rev. & Tax. Code section 25136 (2012)).

²³Cal. Rev. & Tax. Code section 25136.

²⁴Cal. Code Regs. tit. 18, section 25136-2.

²⁵For a detailed discussion of California's market-sourcing provisions and the FTB's related informal rulemaking project, see Gustafson, "California's Ongoing Piecemeal Approach to Market Sourcing," *Tax Notes State*, Apr. 24, 2023, p. 299.

²⁶See FTB Legal Ruling 2022-01 (Mar. 22, 2022).

²⁷The four questions are: who is the customer?; what is the service provided?; what is the benefit being received?; and where is the benefit of the service received by the customer?

²⁸Legal Ruling 2022-01 also overturns two separate FTB chief counsel rulings, CCR 2015-03 and 2017-01, which stood for the proposition that receipts from services are sourced to the location of a taxpayer's direct customer, and not its customer's customers. In contrast, Legal Ruling 2022-01 provides for "look-through" sourcing in certain situations.

²⁹The FTB also administers California's personal income tax.

³⁰FTB Manual of Audit Procedures, section 10.4.3 (rev. Nov. 17, 2024).

³¹See, e.g., *Tenneco West Inc. v. Franchise Tax Board*, 234 Cal. App. 3d 1510, 1537-1538 (Cal. Ct. App. 1991) (applying Legal Ruling 413 for the proposition that "apportionment based upon factors of the year of sale more closely reflects the activities which gave rise to the income" in an installment sale).

and then relied on it as authority before the courts.³²

The OTA considers legal rulings, too, twice refusing to follow a legal ruling offered by the FTB as authoritative because it was inconsistent with existing California statutes. The OTA rejected the FTB's so-called "matching principle" found in Legal Ruling 2006-01.³³ This 17-year-old litigating position asserted that apportionment factors related to deductible income must be excluded from the apportionment formula. First in *Appeal of Southern Minnesota Beet Sugar Cooperative*,³⁴ and again in *Appeal of Microsoft Corp.*,³⁵ the OTA concluded that California's long-standing apportionment provisions did not support any such exclusion.³⁶

Notably, Legal Ruling 2006-01 recently served as the linchpin for a massive shake-up to California's apportionment provisions. Last summer, the California Legislature enacted Rev. & Tax. Code section 25128.9, which adopts the matching principle applied in Legal Ruling 2006-01. The new statute is premised on the ruling and relies on it for the proposition that this matching principle has been in place since California enacted the Uniform Division of Income for Tax Purposes Act in 1966.³⁷

A case can be made that Legal Ruling 2006-01, like TAM 2022-01, is a rule of general applicability interpreting and applying the law — here, California's apportionment statutes — and

therefore constitutes an illegal "underground regulation."³⁸ As mentioned above, recently enacted section 25128.9 is premised on Legal Ruling 2006-01. Query whether the California Legislature would have jettisoned nearly 60 years of statutory interpretation and corresponding California Supreme Court, Court of Appeal, and OTA decisions if it realized that Legal Ruling 2006-01 is an invalid underground regulation.

These questions have yet to be answered. On the whole, though, the benefits of public access to the FTB's positions outweigh the possibility that a tribunal will give undue deference to a particular FTB notice, technical advice memorandum, or legal ruling. The cascading consequences of ACMA are uncertain. It is too early to tell whether the FTB (and California's other tax agencies) will change its mix of informal and formal guidance. Whatever does happen will certainly affect taxpayers in material ways. Stay tuned. ■

³² See, e.g., *Swart Enterprises Inc. v. Franchise Tax Board*, 7 Cal. App. 5th 497, 511-512 (Cal. Ct. App. 2017) (noting that the FTB's contention in the case "was derived from a legal ruling issued by the FTB during the pendency of litigation in this matter" and disagreeing with the FTB's analysis in the legal ruling as to what constitutes "doing business" in the state).

³³ See FTB Legal Ruling 2006-01 (Apr. 28, 2006).

³⁴ *Appeal of Southern Minnesota Beet Sugar Cooperative*, 2023-OTA-342P (Cal. Off. Tax App. Mar. 17, 2023), *pet. for reh'g denied*, 2023-OTA-343 (Cal. Off. Tax App. June 26, 2023) (nonprecedential).

³⁵ *Appeal of Microsoft Corp. & Subsidiaries*, 2024-OTA-130 (Cal. Off. Tax App. July 27, 2023) (nonprecedential), *pet. for reh'g denied*, 2024-OTA-131 (Cal. Off. Tax App. Feb. 14, 2024) (nonprecedential).

³⁶ See *Appeal of Southern Minnesota Beet Sugar Cooperative*, 2023-OTA-342P at 13 ("There is no language in the [UDITPA] to support FTB's position that unitary business activities are excluded from the apportionment formula if they relate to deductible income."); see also *Appeal of Microsoft Corp.*, 2024-OTA-130 at 15 ("FTB's interpretation [in Legal Ruling 2006-01] is inconsistent with well-established law.").

³⁷ *Appeal of Southern Minnesota Beet Sugar Cooperative*, *supra* note 34.

³⁸ Cal. Gov't Code section 11340.9(b) provides that the APA does not apply to a "legal ruling of counsel issued by the Franchise Tax Board." It is an open question whether this exception only applies to chief counsel rulings, or any "ruling" issued by one of the FTB's many attorneys in its Legal Division.