

Alert | State & Local Tax (SALT)



August 2023

California Lawyers Association 2023 State and Local Tax Annual Meeting Roundup

Go-To Guide:

- California Lawyers Association’s SALT Committee held its first fully in-person annual meeting since the start of the pandemic.
- California taxing agencies provided legislative, regulatory, and litigation updates of interest.

The Taxation Section of the California Lawyers Association held its annual State and Local Tax Meeting on July 27, 2023, at the Franchise Tax Board (FTB)’s Central Office in Rancho Cordova, California. This meeting provided practitioners and industry members an opportunity to hear from several leaders at the FTB, California Department of Tax and Fee Administration (CDTFA), California Board of Equalization (BOE), and the Office of Tax Appeals (OTA).

For those who missed the event or who want a double serving of tax, keep reading for the latest developments in California state and local tax.

I. FTB Developments

a. Litigation Update

The FTB panelists provided litigation updates on seven notable cases:

- *The Bahl Media LLC/Wein Realty LLC v. Franchise Tax Board*. The issue in the *Bahl* cases is whether the FTB's application of the "doing business" standard in California Revenue and Taxation Code ("Code") section 23101 violates the Due Process Clause of the United States Constitution. The plaintiffs are all non-California entities whose sole connection to California is an interest in a California LLC. Plaintiffs allege that their interest in a California LLC cannot by themselves constitute "doing business." A hearing on class certification is scheduled for October 2023.
- *Gilbert P. Hyatt v. Franchise Tax Board*. The issue in *Hyatt* is whether the judgment issued by the (Nevada) Clark County District Court in favor of Gilbert Hyatt against FTB, including the award of \$250,000,000 in punitive damages, was proper. This case involved various issues, including a number of constitutional issues and whether FTB was liable for a number of alleged torts. FTB conducted a residency audit of plaintiff. After years of litigation at the Nevada Supreme Court and United States Supreme Court, the issue of costs remains at dispute. The Nevada Supreme Court recently issued an order affirming approximately \$1 million, reversing about \$787,000, and remanding about \$467,000; these costs were granted by the Nevada District Court in favor of the FTB.
- *Paula Trust v. Franchise Tax Board*. This case involved the question of whether Code sections 17041 and 17951, which subject California residents and non-residents to California income tax on all California source income, are applicable to a trust that is subject to tax pursuant to Code section 17743. Plaintiff's main argument was that income received by the trust should be taxable only to the extent that its trustees are residents of California, regardless of the source of the income. An appellate court, reversing the trial court's finding in the plaintiff's favor, held that "[t]he plain language of section 17743 and its rules require taxing all of a trust's California-source income and then apportioning only income derived outside of California according to the number of resident fiduciaries."
- *One Technologies, LLC v. Franchise Tax Board*. A taxpayer is challenging California's mandatory single sales factor apportionment formula on the basis that its passage via Proposition 39, California's Clean Energy Jobs Act approved in November 2012, violates the Single Subject Rule of the California Constitution. FTB demurred to the complaint arguing the provisions of the Act do not violate the Single Subject Rule. The trial court sustained the demurrer. Plaintiff appealed and the case is currently pending before the Court of Appeal.
- *American Catalog Mailers Association v. Franchise Tax Board*. The issue in this case is whether FTB's Publication 1050 and TAM 2022-01, both of which relate to the application of Public Law 86-272, are invalid because they contradict Public Law 86-272 and are underground regulations. ACMA alleges it is a trade association advocating for catalog, online, direct mail, and other remote-selling merchants and their suppliers. FTB demurred, claiming, among other things, ACMA did not have standing. The demurrer was overruled, and the Court of Appeal declined to review the matter this early in the litigation.

b. Regulation Update

The meeting then addressed recent tax regulatory changes. FTB proposed amendments to California Code of Regulations (CCR), title 18, section 25137, subdivision (d), which would provide additional procedural guidance for practitioners and taxpayer filing apportionment variance requests with the FTB and also with the FTB three-member board.

Also, FTB proposed amendments to CCR section 25136-2 in an attempt to simplify existing rules for assigning sales other than sales of tangible personal property. For example, under the proposed amendments, businesses and individuals would have the same rules for assigning sales from services. The presumptions for assigning sales from services would also be simplified and streamlined. As for services provided under government contracts, asset management services receipts, and professional services receipts, assignment rules would be provided under the proposed amendments.

II. CDTFA Developments

CDTFA panelists focused the bulk of their presentation on two components: legislation and litigation. The following two Assembly and Senate bills took effect Jan. 1, 2023:

a. Legislation Update

- SB 125, Lithium Extraction Tax
 - This bill requires any person who extracts lithium from geothermal fluid, spodumene ore, rock, minerals, clay, or any other naturally occurring substance in this state to pay a lithium extraction excise tax upon each metric ton of extracted lithium carbonate equivalent.
- SB 1312, Marketplace Facilitator Act/Rental Car Companies
 - This bill creates an exception to the definition of “marketplace facilitator” for vehicle rental broker. Proponents of this bill claim that these revisions make clear that the marketplace seller is the tax responsible party in car rental transactions facilitated by an online travel company.

b. Litigation Update

The CDTFA panelists also addressed three key cases:

- *Online Merchants Guild v. Maduros*. Plaintiff sought a declaration that CDTFA’s requirement that out-of-state third-party merchants must register with CDTFA and collect use taxes on their retail sales made prior to Oct. 1, 2019 (the effective date of the Marketplace Facilitator Act) was unconstitutional. Plaintiff also sought an injunction to enjoin CDTFA from continuing such tax administration practices as well as damages for CDTFA’s alleged violations of the Internet Freedom Act. The Ninth Circuit Court of Appeal held that the Tax Injunction Act precluded the exercise of federal jurisdiction, thereby affirming the district court’s decision to grant the CDTFA’s motion to dismiss. A petition for a writ of certiorari to the U.S. Supreme Court was denied.
- *Grosz v. CDTFA et al.* Stanley E. Grosz seeks injunctive and declaratory relief pursuant to California Code of Civil Procedure section 526, subdivision a, to compel CDTFA to comply with an alleged mandatory duty to collect sales and use taxes due to the State of California from catalog merchants, with respect to sales of products supplied by third-party vendors. Grosz, who owns a camera shop, is not a participant in the fulfillment by an internet marketplace program and is not claiming damages to himself but claims the state may have lost billions of dollars in unpaid sales taxes it should have

collected from catalog merchants. The Court of Appeal affirmed the lower court's decision to find that Grosz lacked standing to review to bring this suit. The California Supreme Court denied review of this case.

- *Cultiva La Salud et al. v. State of California et al.* A nonprofit health advocacy organization filed suit to challenge the “Keep Groceries Affordable Act of 2018” penalty provision. The Act sought to prohibit charter cities, counties, and other local governments from imposing taxes, fees, or assessments on certain grocery items, including on sodas and other sugar-sweetened drinks. The act also imposes a penalty—the loss of all revenue from sales and use taxes—for violations of its terms. But it imposes its penalty only on charter cities and only if the city’s “tax, fee, or other assessment is a valid exercise of [the] city’s authority under Section 5 of Article XI of the California Constitution with respect to the municipal affairs of that city.” The trial court ultimately agreed the penalty provision was unlawful and deemed it unenforceable because the provision wrongly served to penalize charter cities that lawfully exercised their constitutional rights under the home rule doctrine. The Court of Appeal affirmed.

III. BOE

The BOE focused on updates that involved administrative issues and litigation updates. Since the enactment of Proposition 19, which amended then-existing rules for parent-child and grandparent-grandchild transfers, the BOE has focused a significant amount of resources and time in handling such transfers from taxpayers. The BOE also discussed the reduced timeline for providing legal opinions to taxpayers since the official end of the COVID-19 pandemic. While the BOE was previously taking 12-16 months to produce legal opinions, that timeline has been reduced to 6-9 months.

The BOE also addressed several notable property tax cases, including *Olympic Georgia and Partners LLC v. County of Los Angeles*. The Second District of the California Court of Appeal held that the County of Los Angeles erred by including the value of three intangible assets in the property tax assessment of the Los Angeles Ritz-Carlton and JW Marriott Hotels, owned by Appellant Olympic and Georgia Partners, LLC, which is represented by Greenberg Traurig. Read a more detailed analysis of this case in an [April 2023 GT Alert](#).

IV. OTA

a. Regulation Update

Panelists from the Office of Tax Appeal (OTA) provided key updates regarding the new agency. Assembly Bill 127 Budget Trailer Bill would provide the OTA with a narrow exemption from the Office of Administrative Law (OAL) rulemaking approval process to ensure that OTA's precedential decisions do not require OAL Approval. Because of an OAL holding that bound the Board of Equalization (OTA's predecessor agency), precedential decisions are “underground regulations.” AB 127 would resolve this conflict since the OAL's holding contradicts OTA's mission.

Panelists also discussed deferring a proposed regulatory update that would narrow the OTA's jurisdictional capabilities when it came to questions about the validity of regulations when those regulations conflicted with a statute. Read a more detailed analysis of this proposed change in our [February 2023 GT Alert](#).

b. Litigation Update

The OTA panelists provided litigation updates on complex cases, including the following:

- *Appeal of FAR Investments, 2022-OTA-395P*. The issue in this case was whether an Internal Revenue Code (IRC) section 1031 transaction failed the “exchange requirement.” Appellants were indirect owners in Arciero Wine Group, LLC (AWG), which owned a winery. AWG’s real property included buildings, land, and vineyards (the Paso Property), and its other assets included equipment and inventory. After AWG received an offer to purchase the winery, appellants executed an exchange agreement with an intermediary and separate seller substitution agreement with the buyer expressing an intent to exchange the Paso Property. OTA noted that to qualify for nonrecognition treatment under IRC section 1031, the transaction must be an exchange, among other requirements, meaning the same taxpayer that relinquishes property must also receive the replacement property.
- *Appeal of Smith, 2023-OTA-069P*. The issue in this case was whether for the 2012 tax year, nonresident appellant was liable for tax on a distributive share of gain from the sale of a partnership interest because it constituted California source income. Appellant argued that the FTB’s use of corporate apportionment rules to source the gain to California was incorrect, and personal income tax sourcing would source the income to him out of state, and therefore the income was not subject to California Tax. The FTB argued that CCR section 17951-4(d) is the governing sourcing provision because the partnership is unitary with its holding corporation. The gain is thus properly considered apportionable business income and, under the unitary combination method set forth in CCR section 25137-1(f), it is apportioned to California at the holding company’s level using its share apportionment factors derived from the sold business it held. Consequently, the apportioned gain retains its character as California source income as it flows up from the holding company to its ultimate taxpaying owners, such as appellant.

V. Conclusion

Since the pandemic the SALT annual meeting has gone from virtual, to hybrid, to fully in-person. The meeting will continue to be held in-person at the FTB for the foreseeable future. This meeting provides a rare opportunity for the taxpayer community to interact directly with stakeholders at the California taxing agencies in an informal environment.

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