

California FTB's Interested Parties Process Offers Taxpayers a Voice

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Since Selvi Stanislaus took over the helm of the California Franchise Tax Board four years ago, the FTB has tried to improve transparency and increase taxpayer participation in its policymaking function. Chief among the strategies for increasing openness at the FTB is the interested parties process, which entails a series of informal meetings that precede the formal process to implement or amend regulations. In this Pinch of SALT, we describe the interested parties process and its expanded use at the FTB, evaluate its benefits and drawbacks, and explain how and why taxpayers should participate in it.

Origins and Overview of the Process

The interested parties process is an important component of implementing the FTB's stated goals of improving transparency and accessibility.¹ Interested parties meetings are open forums that allow stakeholders and tax administrators to discuss major policy changes informally and without attribution.² The FTB considers the interested parties process "an essential tool" for it to solicit input from the public on how it does business.³

The process began in earnest in 2006, when legislation was passed to allow domestic partners to

file as married persons on their personal income tax returns.⁴ The FTB anticipated numerous implementation problems with this law change because of a lack of conformity with federal law.⁵ Through the interested parties process, the FTB involved stakeholders affected by the law change, developed forms and instructions, and received helpful feedback from participants.⁶ The FTB held four interested party meetings in 2006 and has since held 47. These meetings have addressed topics ranging from the effect of the California Supreme Court's decisions in *Microsoft v. Franchise Tax Board* and *General Motors v. Franchise Tax Board* to legislation providing for omnibus conformity with federal income tax law.^{7,8}

Formal Rulemaking Process

The formal rulemaking process is more structured than the interested parties meetings.⁹ Once the FTB decides to enter the formal rulemaking process, it must submit the proposed text of the regulation, the Initial Statement of Reasons, the Fiscal Impact Statement, and the Notice of Proposed Regulatory Action to the Office of Administrative Law.¹⁰ The notice must be published in the California Regulatory Notice Register at least 45 days before the hearing, a period that coincides with the

⁴FTB meeting transcript, Apr. 4, 2007, at 9.

⁵*Id.*

⁶*Id.*

⁷A comparison of interested parties meetings held in the last four years with final regulations demonstrates that all final regulations from 2006 to 2010 were preceded by an interested parties process. See http://www.ftb.ca.gov/law/Final_Regulations and <http://www.ftb.ca.gov/law/intParty/Archive/archive>. Although the FTB now chooses to conduct an interested parties process every time it proposes a new regulation, it is not required in every circumstance. Section 11346.45(a) of the California Government Code requires pre-notice public discussions only if the proposal is large or complex.

⁸FTB website/interested parties meetings.

⁹FTB, *supra* note 1, at 1.

¹⁰Calif. Gov't. Code section 11346.2 (West 2011).

¹Franchise Tax Board interested parties meeting process staff report, Apr. 4, 2007, at 1.

²*Id.*

³*Id.*

public comment period.¹¹ A formal rulemaking proceeding is not required unless an interested person requests it in writing at least 15 days before the close of the 45-day comment period.¹² If the FTB decides to change its initial proposal in response to public comments, and the changes are substantial and sufficiently related to the original proposal, it must allow 15 more days for public comment.¹³ The agency must summarize and respond to comments regarding the proposal or the agency's procedure during the rulemaking action and include it in the Final Statement of Reasons.¹⁴

Although the formal rulemaking process can take several months or longer, an agency must submit its rulemaking file to the Office of Administrative Law within one year of the date the notice was published in the California Regulatory Notice Register.¹⁵ It is in the best interests of the FTB to vet complex and controversial issues related to a proposed regulation through the interested parties process, before the clock begins running in the formal rulemaking process.

Participation in the Interested Parties Process Before Formal Rulemaking

It is also in taxpayers' best interests to provide the FTB with feedback while there is time to make changes and respond to comments. At this stage, the FTB can halt the regulation without having invested much time or resources in it, or it can make modifications that will avoid a delay in formal rulemaking.¹⁶ Major departures from the original proposed regulation are more likely to occur before formal rulemaking than after.

Regulation 25137 Is Treasury Receipts Regulation

A look at regulation 25137(c)(1)(D)-(c)(1)(D)(3),¹⁷ which attempted to address the California Supreme

Court's decisions in *Microsoft v. Franchise Tax Board*, 39 Cal. 4th 750 (2006), and *General Motors Corporation v. Franchise Tax Board*, 39 Cal. 4th 773 (2006),¹⁸ shows the strengths and limitations of the interested parties process. In *Microsoft* and *General Motors*, the California Supreme Court addressed whether receipts from the treasury function should be included in the sales factor and whether that inclusion was distortive. The court concluded that the answer was taxpayer specific and failed to articulate a bright-line test.

The FTB invited stakeholders to an interested parties meeting on January 31, 2007, to discuss how to address the uncertainty resulting from the court's decisions.¹⁹ At the first meeting, the FTB asked participants whether: (1) a statute or regulation was more appropriate to address the issue; and (2) whether gross receipts from a corporation's treasury function should be excluded entirely from the sales factor or included only to the extent of net income.²⁰ Forty-nine stakeholders participated, including industry representatives from California and outside the state.²¹ Participants were divided based on whether they were California-based taxpayers or out-of-state taxpayers, with the former preferring to exclude treasury function gross receipts from the sales factor entirely,²² and the latter preferring to include receipts in full or, at a minimum, to the extent of net income.²³ A second interested parties meeting was held on March 30, 2007, to review two

treasury function of the taxpayer's unitary business, as well as the gross receipts and net gains from the "maturity, redemption, sale, exchange or other disposition of such intangible assets." Regulation 25137 (c)(1)(D)(1) defines "treasury function" as "the pooling, management, and investment of intangible assets for the purposes of satisfying the cash flow needs of the trade or business, such as providing liquidity for a taxpayer's business cycle, providing a reserve for business contingencies, business acquisitions, etc. A treasury function includes the use of futures contracts and options contracts to hedge foreign currency fluctuations. A treasury function does not include a taxpayer's trading function that engages in futures and option transactions for the purpose of hedging price risk of the products or commodities consumed, produced, or sold by the taxpayers. A taxpayer principally engaged in the trade or business of purchasing and selling intangible assets of the type typically held in a taxpayer's treasury function, such as a registered broker-dealer, is not performing a treasury function with respect to income so produced."

¹⁸FTB report on GM/Microsoft interested parties meetings, Apr. 4, 2007.

¹⁹FTB, GM/Microsoft interested parties meeting, discussion topics, Jan. 31, 2007.

²⁰*Id.* at 4-5.

²¹FTB, report on GM/Microsoft interested parties meetings at 1.

²²*Id.*

²³Comments of Sutherland Asbill and Brennan on Proposed Regulation 25137(c)(1)(D)-(c)(1)(D)(3), Sept. 17, 2007.

¹¹Calif. Gov't. Code section 11346.4(a) (West 2011).

¹²Calif. Gov't. Code section 11346.8(a) (West 2011).

¹³Calif. Gov't. Code section 11346.8(c) (West 2011).

¹⁴Calif. Gov't. Code section 11346.9(a)(3) (West 2011).

¹⁵Calif. Gov't. Code section 11346.4(b) (West 2011).

¹⁶Many regulatory proposals stalled in the interested parties process without proceeding to formal rulemaking. See, e.g., Proposed Regulation 25137-1 (Apportionment and Allocation of Partnership Income); Proposed Regulation 25137-11 (Trucking Companies — Apportionment and Allocation of Income); Proposed Regulation 25137-12 (Print Media — Apportionment and Allocation of Income); Proposed California Schedule M-3 (California-specific form for disclosing uncertain tax positions). See <http://www.ftb.ca.gov/law/intParty/Archive/archive> and http://www.ftb.ca.gov/law/Final_Regula tions.

¹⁷18 C.C.R. section 25137(c)(1)(D)-(c)(1)(D)(3). As amended, Regulation 25137(c)(1)(D) provides that the numerator and denominator of the sales factor excludes interest and dividends from intangibles held in connection with a

(Footnote continued in next column.)

regulatory proposals and two statutory proposals.²⁴ At that meeting, speakers tended to favor a regulatory approach that excluded treasury function gross receipts entirely from the sales factor.

A fundamental divide remained between in-state companies, which would benefit from a simpler rule of excluding gross receipts from the sales factor, and out-of-state companies, which favored inclusion.²⁵ In response, the FTB modified the proposed regulation to address concerns regarding the exclusion of banks and financial institutions and broker dealers.²⁶ It also created an exemption for raw materials hedging transactions.²⁷ At a hearing on April 4, 2007, the FTB decided to proceed with the formal regulatory process, despite testimony from those who strongly opposed the proposed regulation. The formal process began on June 29, 2007, and a formal regulatory hearing was held on August 17, 2007.²⁸ The rule-making file was submitted on April 29, 2008, and was finalized May 29, 2008.²⁹

The interested parties process took five months, and the formal rulemaking process took 11 months. As the example above shows, fundamental policy differences usually can't be reconciled in the interested parties process, and participants who spent time and resources trying to persuade the FTB not to proceed with the proposed regulation were undoubtedly disappointed. However, all stakeholders were given a voice in the process.

Those who sought to ensure that their clients' activities — such as banking, finance, broker dealer, and raw materials hedging — were exempt from consideration as treasury function activities saw their concerns addressed, as their positions were consistent with the FTB's policy position. The FTB's willingness to include language addressing those concerns in response to comments from the interested parties meetings, as well as its consideration of the stakeholders' preference for a regulation rather than legislation, indicates that there was value to taxpayers participating in the interested parties process. More fundamentally, the dialogue that the process fosters is critical to building trust between taxpayers and the FTB that will be beneficial when controversies arise.

²⁴FTB, interested parties meeting, topics of discussion, Mar. 30, 2007.

²⁵*Supra* note 4, at 17:22-25.

²⁶*Id.* at 14:9-17.

²⁷*Id.* at 14:25-15:2.

²⁸Final Statement of Reasons for Adoption of California Code of Regulations Title 18, section 25137(c)(1)(D), at 1.

²⁹FTB final regulations, available at http://www.ftb.ca.gov/law/Final_Regulations.

State Conformity to 2008 Federal Income Tax Changes

On April 24, 2008, the FTB hosted an interested parties meeting to “elicit public input and obtain consensus” regarding California conformity to 2007 federal income tax law changes.³⁰ Given the number of federal changes, the meeting served to highlight potentially controversial items and identify code sections that might be included in an omnibus conformity bill to be introduced later.

Attendees included legislative staff, trade associations representing the business community, labor union lobbyists, and tax practitioners with an interest in federal conformity. Participants discussed the FTB's recommendations as to which code sections merited California's conformity, as well as estimates regarding the state revenue impact resulting from conformity.³¹

During the meeting, FTB staff described individual federal tax law changes, and participants were encouraged to object to provisions that they believed were inappropriate for the conformity bill. The FTB was then required to submit its recommendations to the authors of the conformity bill, with objections noted.³²

On June 14, 2007, AB 1561, authored by State Assembly member Charles M. Calderon (D), was amended to include the numerous federal tax law changes discussed in the interested parties meeting, and the business community supported the bill.³³ On June 23 the bill was amended to include a controversial provision that had not been discussed in the meeting, regarding omnibus federal income tax conformity. That provision changed California law for calculating controlled foreign corporation income by deleting the inclusion ratios and conforming to federal subpart F requirements to treat the amount of a CFC's subpart F income as a deemed dividend for water's-edge taxpayers, while excluding that income under the state's dividend exclusion and deduction laws.³⁴

The June 23 amendments divided the business community. On August 12, 2008, they were removed from the bill, but they failed to pass the Senate because of Republican legislators who opposed them

³⁰FTB interested parties meeting announcement, California conformity to 2007 federal income tax changes, Apr. 24, 2008.

³¹FTB interested parties meeting agenda, California conformity to 2008 federal income tax changes, Apr. 3, 2009.

³²*See, e.g.*, Franchise Tax Board 2008 conformity decision tables (noting stakeholder objections).

³³*See* AB 1561 (as amended June 14, 2007); Senate Revenue and Taxation Committee, bill analysis, AB 1561, as amended June 23, 2008.

³⁴*Id.*

based on their designation as a tax increase, which would require a two-thirds vote of both houses of the State Legislature.³⁵

A second interested parties meeting was held on April 3, 2009, to discuss 2008 federal income tax law changes.³⁶ On June 26, 2009, Calderon amended AB 1580 to include omnibus conformity with federal law.³⁷ The bill included another controversial provision that imposed a 20 percent penalty on excessive claims for refund.³⁸ Frustrated by the inclusion of a penalty that had not been vetted in the interested parties process, major trade associations opposed the bill.³⁹ Witnesses who opposed the bill argued that the FTB had held an interested parties meeting to develop a consensus-oriented bill and that the omnibus conformity bill should not contain controversial provisions.

Unlike AB 1561, AB 1580 contained provisions that had a significant negative revenue impact that offset the bill's revenue-raising provisions.⁴⁰ Thus, the bill required only a majority vote and received enough Democratic support to reach Republican Gov. Arnold Schwarzenegger's desk.⁴¹ The governor vetoed the bill, stating: "It is disappointing that a multi-year, complex bill on federal tax conformity is damaged when a single provision is inserted at the last minute, especially when the process up to that point had been built on consensus. . . . I would urge the Legislature to send me legislation that demonstrates the agreements reached prior to the inclusion of the last provision on erroneous refund claims."⁴²

On February 5, 2010, Sen. Lois Wolk (D) introduced a third omnibus conformity bill, SB X8 32.⁴³ It included the same controversial penalty and was also vetoed by the governor, who wrote: "This bill is similar to legislation I vetoed last fall. In my veto message, I expressed disappointment that the multi-year process of drafting a consensus bill on

federal tax conformity was derailed by the last-minute insertion of a provision that was objectionable to many of the parties involved in the process. A version of that provision remains in this bill, and as such I cannot support it."⁴⁴

Schwarzenegger finally signed noncontroversial omnibus conformity legislation on April 12, 2010, a full year and four bills after the original interested parties meeting.⁴⁵ Although the stated goal of the meeting to "obtain consensus" was achieved regarding the FTB's conformity recommendations, the FTB had no control over the fate of the final bill. By holding the interested parties meeting, the FTB perhaps unintentionally created the impression that the final conformity bill would be a consensus product, leaving stakeholders feeling betrayed when the authors enacted legislation that was unfriendly to taxpayers.

That result may deter the FTB from holding similar meetings regarding legislation in the future. An interested parties meeting gives stakeholders a sense of control over the final product when none exists. Regardless of the outcome, however, stakeholders benefited from participating in the interested parties process by acquiring knowledge and an understanding of the contents of large and complex legislation.

California's New Market Sourcing Regulations

As covered in previous Pinch of SALT columns,⁴⁶ California recently concluded an interested parties process for regulations to implement its new market sourcing provisions. By statute, taxpayers who elect single-sales-factor apportionment are required to source sales of services to California to the extent that the purchaser of the service received the benefit in California, and sales of intangibles to California to the extent that the property is used in the state.⁴⁷ Developing a method for determining where the benefit of a service is received or where an intangible is used is complex, particularly when trying to balance state tax policy concerns against practical issues taxpayers will face when the rules are implemented.

That complexity is evident by the numerous changes that were made during California's interested parties process. California chose to adopt a

³⁵Unofficial ballot, AB 1561 (as amended Aug. 22, 2008), available at http://www.leginfo.ca.gov/cgi-bin/postquery?bill_number=ab_1561&sess=0708&house=B&author=charles_calderon.

³⁶FTB interested parties meeting announcement, California conformity to 2008 federal income tax changes, Apr. 3, 2009.

³⁷AB 1580 (as amended June 26, 2009).

³⁸Senate Revenue and Taxation Committee, bill analysis, AB 1580, as amended Aug. 18, 2009.

³⁹Senate Rules Committee, bill analysis, AB 1580, as amended Sept. 1, 2009.

⁴⁰Assembly Committee on Appropriations, bill analysis, as amended Sept. 1, 2009.

⁴¹Unofficial ballot, AB 1580, as amended Sept. 1, 2009, available at http://www.leginfo.ca.gov/pub/09-10/bill/asm/ab_1551-1600/ab_1580_vote_20090910_0735PM_asm_floor.html.

⁴²Governor's veto message, AB 1580, Oct. 11, 2009.

⁴³SB X8 32 as introduced, Feb. 5, 2010.

⁴⁴Governor's veto message, SB X8 32, Mar. 25, 2010.

⁴⁵See, e.g. SB 401, Ch. 14, Stats. of 2010.

⁴⁶Pilar Mata and Melissa J. Smith, "A Pinch of SALT: The Implementation of 'Market' Sourcing Rules: Practical Concerns," *State Tax Notes*, Sept. 6, 2010, p. 649, *Doc 2010-18847*, or *2010 STT 172-1*; and Michele Borens, Pilar Mata, and Melissa Smith, "A Pinch of SALT: Understanding California's New Apportionment Regime," *State Tax Notes*, Dec. 6, 2010, p. 703, *Doc 2010-25052*, or *2010 STT 233-1*.

⁴⁷Calif. Revenue and Taxation Code section 25136(b).

series of cascading rules, with different rules for receipts from sales of services to individuals, sales of services to businesses, sales of intangibles, and licenses of intangibles. These rules evolved significantly during the 2010 meetings.⁴⁸

One key change adopted by the FTB was to provide certainty to taxpayers who source the receipts from the sale of services to individuals based on the billing address of the customer. Prior versions of the regulation had stated that the taxpayer or the FTB could overcome the presumption that the billing address location was correct with evidence showing that the benefit of the service was not received at the billing address. In response to taxpayer comments, the FTB agreed to amend the proposed regulation to provide taxpayers with a safe harbor if they elected to source based on the address, in order to avoid potential disputes with audit staff.⁴⁹ Unfortunately, the FTB rejected taxpayers' requests for a similar safe harbor under the sourcing rules for the sales of services to businesses and for receipts from the sale or license of intangibles.

The FTB also made significant changes to the rules for sourcing receipts from the licensing of intangibles. Earlier drafts of the regulation would have sourced such receipts to the extent the intangible was used in the state, based on the contract terms, a reasonable approximation or the customer's commercial domicile. The most recent version of the proposed regulation distinguishes between marketing intangibles, manufacturing intangibles, and mixed intangibles.⁵⁰ Receipts from marketing intangibles are to be sourced to the location of the ultimate consumer and receipts from manufacturing

intangibles are to be sourced to the state where the intangible is used. Receipts from mixed intangibles (that is, marketing and manufacturing), if separately stated and reasonable, are to be sourced according to both the marketing and manufacturing rules.

With California's market-sourcing statute going into effect as of January 1, 2011, the FTB has opted to proceed with the formal rulemaking process. Taxpayers affected by the new market sourcing rules should participate in that process, which is expected to result in a final regulation by the end of 2011.

Conclusion

Taxpayers and their representatives should view the interested parties process as an opportunity to understand or become familiar with the FTB's mindset regarding regulatory proposals and to help shape FTB policy. They should participate in the process from the first scheduled meeting and not wait until the formal rulemaking process has commenced, when the FTB has become more invested in its stated position and has less time to address concerns.

Although the interested parties process does not always produce the desired outcome, it helps provide information regarding pending policy decisions and access to FTB staff. Also, ongoing dialogue with the FTB in an informal environment leads to mutual trust and an improved working relationship that will be helpful in future tax disagreements. ☆

⁴⁸California's interested parties meetings on the proposed market sourcing regulation took place on February 10, 2010, July 19, 2010, and November 8, 2010.

⁴⁹Request for permission to proceed with formal regulation process on renumbering regulation 25136 as regulation 25136(a) and to adopt new regulation section 25136(b).

⁵⁰Marketing intangibles include licenses of "a copyright, service mark, trademark, or trade name where the value lies predominantly in the marketing of the intangible property in connection with goods, services, or other items." Proposed Regulation 25136(b)(5)(A). Non-marketing and manufacturing intangibles includes "the license of a patent, copyright, or trade secrets to be used in a manufacturing process, where the value of the intangible lies predominantly in its use in such process." Proposed Regulation 25136(b)(5)(B).

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