



# TaxNewsFlash

## United States

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### California: Combined reporting upheld; different treatment of interstate, intrastate businesses

The California Court of Appeal, Fourth District, has held that California's differential treatment of interstate and intrastate businesses (i.e., requiring interstate unitary businesses to file combined, but allowing intrastate unitary businesses to elect to file separately or combined) does not violate the Commerce Clause.

The case is: *Harley-Davidson, Inc. v. California Franchise Tax Board*, D071669 (Cal. Ct. App. August 22, 2018). Read the [Court of Appeal decision](#) [PDF 122 KB]

#### Background

In 2015, the Court of Appeal, Fourth District concluded—in a case involving multiple issues—that allowing intrastate unitary businesses to choose to file combined or separately, but requiring interstate unitary businesses to file combined, was discriminatory. The case was remanded to a trial court to determine whether the differential treatment advanced a legitimate local purpose that could not be adequately served by reasonable nondiscriminatory alternatives.

On remand, the Franchise Tax Board (FTB) argued that the Court of Appeal, Fourth District merely concluded that the taxpayer sufficiently demonstrated discrimination for the purposes of overcoming demurrer, but did not so hold on the merits.

In 2016, the trial court agreed with the FTB and held that the appeals court's finding on discrimination was sufficient only for purposes of sustaining the demurrer. This put the issue of discrimination back before the trial court, and the trial court held that summary judgment was proper with respect to two issues: (1) whether discrimination existed; and (2) whether the discrimination could survive strict scrutiny (i.e., whether there was a legitimate state purpose for the discriminatory treatment that could not be resolved through a nondiscriminatory alternative). Although the trial court determined there was a "triable" question on the discrimination claim, it found in the FTB's favor

on the strict scrutiny issue. Notably, the court held that the state had a valid interest in accurately measuring and taxing all income from the interstate unitary business that is attributable to the state, and there did not appear to be a reasonable nondiscriminatory alternative to the differential treatment.

## **Court of Appeal**

The Court of Appeal, Fourth District once again affirmed the judgment of the trial court. First, the appellate court agreed that there were triable issues of fact around the issue of discrimination. However, as the trial court had held, it was not necessary to address these issues because legitimate state interests justified the disparate reporting rule. Specifically, the appellate court found that “there is a legitimate state interest to require combined reporting of taxable income of interstate unitary businesses, to accurately measure and tax all income attributable to California that outweighs any possible discriminatory effect.” In the court’s view, separate accounting could not be extended to interstate corporations because it ignored or inadequately captured the transfers of value that take place among the many entities that that can make up a unitary enterprise, and could lead to “the manipulation and hiding of taxable income.” The taxpayer, the court noted, had not pointed to any facts in the record to dispute these conclusions.

The court next addressed whether there were reasonable alternatives to the differential treatment, and held that the taxpayer had not convinced the court that prohibiting intrastate businesses from choosing between separate and combined reporting would be a reasonable alternative. As the court found, given that all income of wholly intrastate businesses is taxed by California, there was less opportunity for intrastate businesses to hide and manipulate taxable income among separate entities. In sum, intrastate entities were not similar to interstate entities for purposes of filing taxes.

The court also agreed with the FTB that it had not previously held that the difference in permissible methods of reporting facially discriminated against interstate unitary businesses. Rather, the court confirmed that its holding was for purposes of the taxpayer’s case surviving the FTB’s demurrer—essentially to keep the case moving forward. The court also rejected the FTB’s position that the taxpayer had to demonstrate the amount of taxes it overpaid as a result of the alleged discriminatory statutes.

## **KPMG observation**

It remains to be seen whether the taxpayer will seek California Supreme Court review.

Read an [August 2018 report](#) [PDF 29 KB] prepared by KPMG LLP

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