

California court addresses “elective” separate accounting and agency nexus

June 23, 2015

Overview

The California Court of Appeal recently issued a decision in *Harley-Davidson, Inc., v. Franchise Tax Board*, concluding that the trial court erred in sustaining the Franchise Tax Board’s (FTB) demurrer to the taxpayer’s U.S. Commerce Clause challenge of California Revenue and Taxation Code section (section) 25101.15.¹ Section 25101.15 allows intrastate unitary businesses to choose annually whether to compute their tax using the combined reporting method or the separate accounting method, but requires interstate unitary businesses to compute tax using only the combined reporting method. The taxpayer based its challenge on the assertion that this statutory scheme facially discriminates against interstate businesses in violation of the Commerce Clause. In holding for the taxpayer, the Court of Appeal ruled that “the statutory scheme facially discriminates on the basis of an interstate element in violation of the [C]ommerce [C]ause[.]” reversed the trial court’s decision, and remanded the case to the trial court with instructions that it determine “whether the taxation scheme . . . ‘advances a legitimate local purpose that cannot be adequately served by reasonable nondiscriminatory alternatives.’”²

The Court of Appeal also concluded that the taxpayer’s two special purpose entities, which were engaged in owning and holding loans that originated from customer purchase finance contracts, had taxable nexus in California due to the activities of a related entity that the trial court found was acting as the special purpose entities’ agent.³

In this Tax Alert we summarize the Court of Appeal’s decision and provide some taxpayer considerations.

Elective separate reporting

The Court of Appeal found that the trial court erred in sustaining the FTB’s demurrer that dismissed the taxpayer’s Commerce Clause challenge of section 25101.15.⁴ The taxpayer had argued that the statute was discriminatory in that it allowed intrastate unitary businesses to choose to file on either a combined reporting method or use separate accounting, but did not provide the same choice to interstate unitary businesses, which are required to file on a combined reporting basis.

Under the Commerce Clause, it is impermissible for states to make laws that “unjustifiably . . . discriminate against or burden the interstate flow of articles of commerce.”⁵ Based on Commerce Clause precedents, the court analyzed the statute’s constitutionality by determining whether:

- (1) The relevant aspect of California’s tax scheme treats intrastate and interstate unitary businesses differently,
- (2) Any differential treatment discriminates against interstate commerce either by benefiting intrastate businesses or burdening interstate businesses, and
- (3) Any discriminatory differential treatment withstands strict scrutiny.⁶

¹ *Harley-Davidson v. Franchise Tax Board*, D064241 (Cal. Ct. App. May 28, 2015), slip op. at 16. A copy of the court’s decision is available [here](#).

² *Id.* at 2, 17, citing *Oregon Waste Systems, Inc. v. Department of Environmental Quality of Ore.*, 511 U.S. 93, 100-101 (1994).

³ *Harley-Davidson*, slip op. at 30-35,

⁴ *Id.* at 16.

⁵ *Id.* at 6, citing *Oregon Waste Systems, Inc.*, 511 U.S. at 98.

⁶ *Harley-Davidson*, slip op. at 8-9, citing *Oregon Waste Systems, Inc.*, 511 U.S. at 99-101.

The court found that the FTB conceded the first prong of the analysis because the FTB acknowledged in its briefing that section 25101.15 treats the two groups of taxpayers differently.⁷ The bulk of the court's analysis addressed whether the differential treatment discriminates against interstate commerce.

The taxpayer alleged that the option to file using a separate accounting method allows intrastate taxpayers the "ability to more efficiently use credits and net operating losses, [a] reduced tax burden, increased administrative ease and lower compliance costs in preparing returns"⁸ Based on this allegation,⁹ the Court of Appeal made the "unavoidable conclusion that California's statutory scheme for determining how unitary businesses compute their California tax liability 'discriminates on its face on the basis of an interstate element in violation of the [C]ommerce [C]lause'" because whether a unitary business can choose to calculate its California tax on a separate or combined reporting basis "is determined solely by where the unitary business engages in commerce."¹⁰

Regarding the third part of the analysis—namely, whether the discriminatory treatment may withstand strict scrutiny—the FTB argued that "the state has offered a legitimate reason to impose the discriminatory treatment" in that permitting a "multistate unitary businesses to file on a separate basis is subject to *manipulation*, and does not *accurately* reflect in-state income and values attributable to . . . [such] business[es] in ways that do not exist for in-state businesses,' thus 'depriv[ing] California of much needed tax revenue.'"¹¹ Because the FTB raised this issue for the first time on appeal, and there was not factual development at the trial court due to the demurrer, the Court of Appeal remanded the case back to the trial court to further develop the record regarding whether the FTB can identify a legitimate reason for the discriminatory treatment between intrastate and interstate taxpayers, and whether that reason could be "adequately served by reasonable nondiscriminatory alternatives."¹²

Taxable nexus

The Court of Appeal sustained the trial court's determination that two special purpose entities (SPEs), which acquired and securitized loans made to Harley-Davidson customers, had California nexus (despite having no physical presence in the state) due to what the FTB alleged was an agency relationship with another unitary group member that did have physical presence in California.

Harley-Davidson motorcycle sales are conducted through independent dealers located across the country, including California. For the years in question, Harley-Davidson's combined group included:

- Harley-Davidson Financial Services (HDFS), a Chicago-based entity that provided administrative services to its subsidiaries and employed regional managers who were responsible for educating Harley-Davidson dealers on the finance and insurance products that were offered by HDFS subsidiaries.
- Harley-Davidson Credit Corporation (HDCC), an HDFS subsidiary that purchased loans that originated from motorcycle customer purchase finance contracts entered into by a Harley-Davidson-affiliated bank or by Harley-Davidson's independent dealers, made loans to such dealers, and performed collection activities, including repossession and sale of motorcycles at California auctions.
- The two SPEs, wholly owned subsidiaries of HDCC that purchased pools of securitized loans from HDCC in order to generate liquidity.
 - As owners of the loans, the SPEs were responsible for servicing them, which they performed by entering into servicing contracts with HDCC.

The trial court ruled that HDFS and HDCC acted as the agents of the SPEs, and that the activities of those companies created nexus in California.

⁷ *Harley-Davidson*, slip op. at 9.

⁸ *Id.* at 6.

⁹ Because the Court of Appeal was reviewing an order sustaining a demurrer, the court stated it must assume the truth of properly pleaded factual allegations, facts reasonably inferred from those expressly pleaded, and matters of which judicial notice has been taken. *Id.* at 3, n.2, citing *Schifando v. City of Los Angeles*, 31 Cal.4th 1074, 1081 (2003).

¹⁰ *Harley-Davidson*, slip op. at 13.

¹¹ *Id.* at 16.

¹² *Id.* at 17.

In reviewing the trial court's determination that the SPEs had California nexus, the Court of Appeal conducted a two-part analysis. First, the court reviewed whether there was substantial evidence of an agency relationship, concluding that "although the SPEs are legally separate entities from HDCC, substantial evidence supports the trial court's finding of an agency relationship between the SPEs and HDCC."¹³ Among other factors, the Court of Appeal noted:

HDCC undertook collection activities on the SPEs' loans, and it was an HDCC employee who visited an auction house in California on 17 days total to assist in the auction process—a process designed to ensure the value of the collateral securing the loans held by the SPEs. This evidence, and the reasonable inferences derived from it, support the trial court's finding that HDCC was the SPEs' agent.¹⁴

In making this determination, the Court of Appeal rejected the taxpayer's argument that a "more rigid, three-factor test for determining . . . an agency relationship" was required.¹⁵ The court also rejected the taxpayer's assertion that "HDCC could not have been active as the SPEs' agent simply because HDCC's actions also happened to benefit itself."¹⁶

In the second part of its analysis, the Court of Appeal looked at whether the SPEs' nexus satisfied both the Due Process Clause and the Commerce Clause. Regarding the Due Process Clause, the court concluded that the SPEs, through their agent HDCC, had sufficient minimum contacts with California so as "to not offend 'traditional notions of fair play and substantial justice.'"¹⁷ Accordingly, the court held that "the SPEs had sufficient nexus with California to satisfy due process concerns."¹⁸ In rendering this determination the court noted that "the loan pools contained more loans from California than from any other state[.]" and reiterated the relevance of the collection activities in that "HDCC—as the SPEs' agent—oversaw . . . repossession and sale of the motorcycles at California auctions."¹⁹

Regarding the Commerce Clause, the Court of Appeal rejected the taxpayer's contention that the SPEs lacked the requisite California physical presence, concluding that the California activity of the SPEs' agent, HDCC, was sufficient physical presence.²⁰ As explained by the court, "An agent's presence satisfies the physical presence requirement[.]"²¹ however, the court emphasized that "the in-state conduct" of the agent must be "an integral and crucial aspect of the business . . ."²² Analogizing to the facts in *Illinois Commercial*, the court reasoned:

Participating in auctions of repossessed motorcycles to maintain the value of the security interests underlying the securitized loan pools is as integral and crucial to the SPEs' securitization business as was the investigation and adjustment of insurance claims to the insurer in *Illinois Commercial*.²³

Based on the foregoing, HDCC's collection activities on behalf of the SPEs were viewed by the Court of Appeal as sufficient to establish substantial nexus for Commerce Clause purposes.²⁴

Considerations

This case remains pending on remand to determine whether the California taxation scheme withstands strict scrutiny.²⁵ Accordingly, the case is not yet final. Although the case remains pending, taxpayers may wish to consider the following:

¹³ *Id.* at 28.

¹⁴ *Id.*

¹⁵ *Id.* at 29.

¹⁶ *Id.* at 30.

¹⁷ *Id.*, citing *Quill Corp. v. North Dakota*, 504 U.S. 298, 307.

¹⁸ *Harley-Davidson*, slip op. at 32.

¹⁹ *Id.* at 30-31.

²⁰ *Id.* at 33, 35.

²¹ *Id.* at 33, citing *Tyler Pipe Industries v. Dept. of Revenue*, 483 U.S. 232, 250 (1987); *Scripto v. Carson*, 362 U.S. 207, 211-212 (1960); *Illinois Commercial Men's Assn. v. State Bd. Of Equalization*, 34 Cal.3d 839, 849 (1983); *Borders Online v. State Bd. of Equalization*, 129 Cal.App.4th 1179, 1189-1190 (2005).

²² *Harley-Davidson*, slip op. at 33, citing *Illinois Commercial*, 34 Cal.3d at 840.

²³ *Harley-Davidson*, slip op. at 34. Note that in *Illinois Commercial*, taxpayer insurance company's agents' "investigation and settlement of claims . . ." was deemed "an integral and crucial aspect of the business . . ." *Illinois Commercial*, 34 Cal.3d at 840.

²⁴ *Harley-Davidson*, slip op. at 35.

²⁵ As noted previously, the issue on remand is "whether the taxation scheme . . . 'advances a legitimate local purpose that cannot be adequately served by reasonable nondiscriminatory alternatives.'" *Harley-Davidson*, slip op. at 2, 17, citing *Oregon Waste Systems, Inc.*, 511 U.S. at 100-101.

- (1) The implications of computing their tax on a separate accounting basis for open years, the pros and cons of filing separately, and any potential benefit to be derived from filing protective refund claims, where applicable.
 - a. Taxpayers should note that if the California courts ultimately find that section 25101.15 passes the strict scrutiny test, elections to file separately on an originally filed tax return could be subject to penalties including the Large Corporate Understatement Penalty.²⁶
- (2) The guidance of U.S. Supreme Court cases such as *McKesson Corp. v. Division of Alcoholic Beverages and Tobacco*, 496 U.S. 18 (1990), which provides that remedies where a tax is held to be discriminatory are generally limited to either allowing the discriminatory benefit to all taxpayers or taking the discriminatory benefit away from all taxpayers.
- (3) Their California nexus profile in light of the Court of Appeal's analysis.

Contacts

If you have questions regarding this California Court of Appeal decision or other California tax matters, please contact any of the following Deloitte Tax LLP professionals.

Bart Baer

Principal
Deloitte Tax LLP, San Francisco
+1 415 783 6090

Steve West

Director
Deloitte Tax LLP, Los Angeles
+1 213 688 5339

Ashley Klaus

Senior Manager
Deloitte Tax LLP, Portland
+1 503 727 5372

The authors of this alert would like to acknowledge the contributions of Lauren Knapp to the drafting process. Lauren is a Tax senior working in the San Francisco Multistate Tax practice of Deloitte Tax LLP.

This alert contains general information only and Deloitte is not, by means of this alert, rendering accounting, business, financial, investment, legal, tax, or other professional advice or services. This alert is not a substitute for such professional advice or services, nor should it be used as a basis for any decision or action that may affect your business. Before making any decision or taking any action that may affect your business, you should consult a qualified professional advisor. Deloitte shall not be responsible for any loss sustained by any person who relies on this alert.

About Deloitte

Deloitte refers to one or more of Deloitte Touche Tohmatsu Limited, a UK private company limited by guarantee ("DTTL"), its network of member firms, and their related entities. DTTL and each of which is a legally separate and independent entity. DTTL (also referred to as "Deloitte Global") does not provide services to clients. Please see www.deloitte.com/about for a detailed description of DTTL and its member firms. Please see www.deloitte.com/us/about for a detailed description of the legal structure of Deloitte LLP and its subsidiaries. Certain services may not be available to attest clients under the rules and regulations of public accounting.

Copyright © 2015 Deloitte Development LLC. All rights reserved.
Member of Deloitte Touche Tohmatsu Limited

²⁶ Cal. Rev. & Tax Code § 19138.