



# SALT Alert!



## SALT Alert! 2018-12: California's Combined Reporting Scheme Passes Latest Challenge

**In *Harley-Davidson v. FTB*, the California Court of Appeal, Fourth District, 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) did not violate the Commerce Clause.**

### Background

Recall, in the 2015 *Harley-Davidson* case, 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.

On October 31, 2016, the trial court agreed with the FTB and held that the appeals court ruling 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 ruled 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 Decision

On review before the Court of Appeal, Fourth District once again, the court affirmed the judgment of the trial court. First, the 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 because legitimate state interests justified the disparate reporting rule. Specifically, the 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.” Harley-Davidson, 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 Harley-Davidson had not convinced the court that prohibiting intrastate businesses from choosing between separate and combined reporting would be a reasonable alternative. Given that all income of wholly intrastate businesses is taxed by California, there is less opportunity for intrastate businesses to hide and manipulate taxable income among separate entities. In sum, intrastate entities are not similar to interstate entities for purposes of filing taxes.

The court also agreed with the FTB that it did not previously hold 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 Harley-Davidson had to demonstrate the amount of taxes it overpaid as a result of the alleged discriminatory statutes. It remains to be seen whether the taxpayer will seek California Supreme Court review.

## Contacts

Please contact [Scot Grierson](#) at 949-885-5643 or [Candace Axline](#) at 858-750-7241 with questions on *Harley-Davidson, Inc. & Subsidiaries v. Cal. Franchise Tax Bd.* (Aug. 22, 2018).