SUPERIOR COURT OF CALIFORNIA,
COUNTY OF SAN DIEGO
CENTRAL

MINUTE ORDER

DATE: 10/31/2016 TIME: 04:28:00 PM DEPT: C-66

JUDICIAL OFFICER PRESIDING: Joel M. Pressman
CLERK: Lori Urie
REPORTER/ERM: Not Reported
BAILIFF/COURT ATTENDANT:

CASE NO: **37-2011-00100846-CU-MC-CTL** CASE INIT.DATE: 11/09/2011
CASE TITLE: **HARLEY-DAVIDSON INC & SUBSIDIARIES vs. CALIFORNIA FRANCHISE TAX BOARD [IMAGED]**
CASE CATEGORY: Civil - Unlimited CASE TYPE: Misc Complaints - Other

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APPEARANCES

The Court, having taken the above-entitled matter under submission on 10/21/16 and having fully considered the arguments of all parties, both written and oral, as well as the evidence presented, now rules as follows:

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All Objections to Evidence are OVERRULED.

Harley-Davidson, Inc.'s Motion for Summary Judgment is DENIED. California Franchise Tax Board's Motion for Summary Judgment is GRANTED.

Harley's core contention in this case is that Revenue and Taxation Code section 25101.15 violates Article I, Section 3, Clause 8 of the United States Constitution: "[The Congress shall have the power to...] regulate Commerce with foreign Nations, and among the several States..." Harley's position is that as an interstate unitary business, it suffers discrimination because it is not given the same choice provided to a unitary business located within the state under section 25101.15.

Failure to Exhaust Administrative Remedies

The Board first argues that Harley failed to exhaust administrative remedies. It is undisputed that this matter is governed by Cal. Rev. & Tax. Code § 19382, which provides a taxpayer may bring a Superior Court action for a tax refund after "denial by the Franchise Tax Board of a claim for refund ... upon the grounds set forth in that claim for refund..." Plaintiffs are required to exhaust administrative remedies, showing that the grounds raised in this action seeking return of funds allegedly overpaid were raised in their administrative claim for refund. (Rev. & Tax. Code, § 6933.) The court is without jurisdiction to consider grounds not set forth in an administrative claim for refund. (Atari, Inc. v. State Bd. of Equalization (1985) 170 Cal.App.3d 665, 672-673; Jimmy Swaggart Ministries v. State Bd. of

Equalization, supra, 204 Cal.App.3d 1269, 1290-1291, affirmed, Jimmy Swaggart Ministries v. Board of Equalization (1990) 493 U.S. 378 [11 0 S.Ct. 688, 107 L.Ed.2d 796].)

The Board argues that while Harley provided an administrative claim for refund, Harley asserted that the lack of a choice of reporting methods caused some unspecified amount of damages. (SOF ¶ 20.) According to the Board, the claim did not explain *how much of the alleged overpayment,* if any, was attributable. "The claim submitted to FIB offered no alleged facts or analysis explaining how it was that lack of a choice of reporting methods cost Harley an extra $ 1,851,942.00. The claim did not include anything about higher taxes caused by a mix of financial and non-financial entities in a unitary business, or about a right to offset for compliance costs, or what those costs were or how they were arrived at."

However, refund claims are liberally construed, and they need only provide Defendant notice of the grounds for the refund. J.H. McKnight Ranch, Inc. v. Franchise Tax Ed., 110 Cal. App. 4th 978, 989 (2003) (refund claim must only give "some reasonable means of ascertaining' therefrom what the claim of the applicant is, to the end that such claims may be investigated by the assessing authorities prior to the hearing.").

Plaintiffs' claim stated generally that allowing intrastate taxpayers "to compute their California tax on a combined or separate return basis" while disallowing the same to interstate taxpayers violates the Commerce Clause. This is sufficient to provide "reasonable means of ascertaining" Plaintiffs' claims. The claim for refund statute requires the taxpayer to state the "specific grounds" on which it is based but does appear to require computation of the exact amount at issue. Cal. Rev. & Tax. Code § 19322. There is no authority that a taxpayer has to state in its claim for refund all "facts and issues" that it will raise in its lawsuit.

Court of Appeal's Decision in Harley-Davidson, Inc. v. Franchise Tax Bd., 237 Cal. App. 4th 193 (2015)

The parties have a fundamental disagreement about the Court of Appeal's decision in this case and its effect on this motion. The Court of Appeal reversed this Court's demurrer ruling and held Harley stated a valid cause of action for unconstitutional discrimination, and that if discrimination were present, it could only be validated if it were to pass strict scrutiny. Harley maintains that the Court of Appeal opinion in this matter found as a matter of law that Section 25101.15 discriminates against interstate commerce.

However, as to Commerce Clause issue at issue in this motion, the Court of Appeal reversed a *grant of demurrer* as to this particular cause of action. The Court stated clearly in disposing of the issue: "The judgment is reversed to the extent it is based on the superior court's order sustaining the Board's demurrer to Harley-Davidson's first cause of action. "The order sustaining the demurrer as to the first cause of action is vacated and the superior court is directed to enter an order overruling the demurrer as to that claim and to conduct further proceedings consistent with this opinion." (Id. at 219-20.) The Court agrees with the Board that a demurrer merely tests the sufficiency of the allegations of a pleading. (Code Civ. Proc. § 430.30; Gervase v. Superior Court (1995) 31 Cal.App.4th 1218.) In a demurrer context, the facts alleged by plaintiff are deemed true only for the purpose of determining whether a claim has been stated. (McHugh v. Howard (1958) 165 Cal.App.2d 169.)

In ruling on the Commerce Clause allegations, the Court of Appeal stated:

"We conclude Harley-Davidson *has alleged* a commerce clause violation sufficiently to withstand the Board's demurrer." (Harley-Davidson, Inc v. Franchise Tax Board (2015) 237 Cal.App.4th

193, 199, emphasis added.) "The Board also argues that any differential treatment is not discriminatory because it neither benefits intrastate businesses nor burdens interstate ones. We must reject this argument, however, because Harley-Davidson's complaint *alleges* the existence of those benefits and burdens and we accept that allegation as true in the context of reviewing an order sustaining a demurrer." (Id. at 206, emphasis added, footnotes and citation omitted.)

The Court of Appeal concluded its analysis, stating: "In summary, Harley-Davidson has *sufficiently alleged* for purposes of surviving the Board's demurrer that the differential treatment of intrastate and interstate unitary businesses is discriminatory within the meaning ascribed by commerce clause precedent." (Id. at 207, emphasis added.)

Thus, based on the Court of Appeal's ruling and general principles of pleading and demurrers, the ruling only holds that the pleading was sufficient. Summary judgment is both proper on both the issue of whether the differential treatment is discriminatory and the issue of strict scrutiny.

Commerce Clause Overview

The basic analysis under the Commerce Clause is not in dispute. The Court is to determine 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. Harley-Davidson, Inc v. Franchise Tax Bd. (2015) 237 Cal. App. 4th 193, 201-202.

Discrimination

For purposes of this motion, it is conceded that the relevant aspects of the tax scheme in question treats intrastate and interstate unitary businesses differently. The question becomes whether the differential treatment discriminates against interstate commerce. As stated above, the Court does not agree with Harley that the Court of Appeal has resolved this issue – it could not because it was only ruling on the viability of allegations in a pleading.

Harley challenges the combined reporting required for interstate unitary businesses as discriminatory. There are currently two methods for corporate tax payers to compute California tax: combined reporting and separate reporting. Separate reporting is that each member of a unitary business files a report of all its income and is taxed by California on that income without apportionment. Combined reporting allows unitary businesses to file as a single business enterprise. For interstate filers, combined reporting is required. Under the applicable provisions, a unitary business files a combined report of all its income from all sources, which is then apportioned using a formula to determine how much of the total business income is attributable to California for tax purposes. Once the amount of business income apportionable to California is determined, that amount is then apportioned among members of the unitary business who are actually California taxpayers, to determine the tax liability of each of those entities. (See, Section 25106.5 and 18 CCR 25106.5-0.)

Arguing merely that there is a choice without more does not equate to discrimination. The test is whether differential treatment actually burdens interstate commerce. The question is whether Harley has articulated a burden either by showing a benefit to intrastate businesses or a burden on the interstate businesses. The Court has read and considered the expert declaration of Brian Pedersen and concludes that there would be a triable issue on discrimination. In conclusion, Pedersen opines that

restricting interstate unitary groups to combined reporting method results in greater compliance and administrative burdens due to the complexity and subjectivity of unity and apportionment rules and highly technical nature of combined reporting calculations. He states that combined reporting may result in increased total tax burden that would be avoided under separate accounting, or even if the total tax is the same under combine reporting. He also states that separate accounting does not permit intrastate unitary groups to omit taxable income from the California tax base. Separate accounting does not allow taxpayers to allocate income among related corporations.

Strict Scrutiny

Even assuming discrimination, the statute in question would be subject to strict scrutiny under the Commerce Clause, and this court would need to apply the strict scrutiny analysis in the first instance. While the test is referred to as "strict scrutiny", to survive, a discriminatory statute need only be "legitimate" rather than "compelling". (C&A Carbone, Inc. v. Town of Clarkstown (1994) 511 U.S. 383, 392-94.) The State has a legitimate interest in avoiding the "disruption of public services that are dependent on [tax] revenue". (Loeffler v. Target Corp. (2014) 58 Ca1.4th 1081, 1101.)

The U.S. Supreme Court has held that a state has an interest in accurately measuring unitary business income. The unitary business principle, the foundation of combined reporting, was developed by the United States Supreme Court as a constitutional restraint "on a State's power to tax value earned outside of its borders". (Allied-Signal, Inc. v. Dir., Div. of Taxation (1992) 504 U.S. 768, 784; Container Corp. of America v. Franchise Tax Board (1983) 463 US 159, 164-65. There appears to be a legitimate state interest in requiring this form of combined reporting to ensure that all business income from interstate business is accurately accounted for that that it is fairly apportioned. The state has a valid interest in preventing the manipulation and hiding of taxable income. See Barclays Bank, PLC v. Franchise Tax Board (1994) 512 U.S. 298, 303.

There does not appear to be a reasonable nondiscriminatory alternative that would adequately serve the state's interest. The alternative of allowing separate reporting for out of state business would potentially omit income of certain entities doing business outside the state.

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Central
330 West Broadway
San Diego, CA 92101

SHORT TITLE: HARLEY-DAVIDSON INC & SUBSIDIARIES vs. CALIFORNIA FRANCHISE TAX BOARD [IMAGED]

CLERK'S CERTIFICATE OF SERVICE BY MAIL	CASE NUMBER: **37-2011-00100846-CU-MC-CTL**

I certify that I am not a party to this cause. I certify that a true copy of the attached minute order was mailed following standard court practices in a sealed envelope with postage fully prepaid, addressed as indicated below. The mailing and this certification occurred at San Diego, California, on 11/01/2016.

Clerk of the Court, by: L. Orie _____, Deputy

TIM NADER
DEPUTY ATTORNEY GENERAL
P.O.BOX 85266
SAN DIEGO, CA 92186-5266

AMY SILVERSTEIN
SILVERSTEIN & POMERANTZ LLP
12 GOUGH STREET # 202
SAN FRANCISCO, CA 94103-1270

☐ Additional names and address attached.