



California Trial Court Holds That Use of a Separate Company Limitation for Claiming Tax Credits Generated by a Unitary Business is Not Inconsistent with Unitary Business Principles

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Over 50 years ago in *Edison California Stores v. McColgan*, 30 Cal.2d 472 (1947) the California Supreme Court upheld the use of a combined report when a unitary business is conducted by multiple corporations. In doing so, a fundamental principle emerged, namely, a business which is unitary is treated as a unit and should have the same tax liability whether it is carried on by separate corporations or by divisions of a single corporation. Recently, a California trial court¹ rejected this fundamental unitary principle when unitary tax credits are involved. In *Atkinson*, the trial court held that a solar energy tax credit which was generated by the taxpayer's unitary business activities could be neither claimed by the unitary group as a whole nor apportioned to each unitary member subject to California tax through the intrastate apportionment rules. Rather, following extensive briefing and the presentation of expert testimony by both parties, the Court found notwithstanding the Franchise Tax Board's ("FTB") expansive use of the term "taxpayer" in other contexts, only the separate corporation qualifying for the credit was entitled to claim the credit. The decision, if upheld on appeal, could have ramifications affecting other credits, such as research and development and manufacturers investment, which are generated by a unitary business.

Introduction

The solar energy tax credit was provided for in 1976 through the enactment of Revenue and Taxation Code ("RTC") section 23601 and was repealed, effective January 1, 1987, by its own terms. The limits and other requirements regarding the credit varied during the years prior to the period in issue (1984-88). During the years

1984 through 1988, RTC § 23601 provided for a tax credit to any taxpayer investing in a qualified solar energy device. The amount of the credit was limited to a percentage of the cost incurred by the taxpayer for any solar energy system installed on its premises. Alternatively, in lieu of claiming the tax credit, the taxpayer could elect to take depreciation deductions pursuant to RTC § 24349.

RTC § 23037 defines "taxpayer" as "any person or bank subject to tax imposed under Chapter 2, Chapter 2.5 or Chapter 3 of this part [California Bank and Corporation Tax Law ("B&CTL)]." RTC § 23030 provides a limitation on the definition of taxpayer in RTC § 23037 and states:

"Except where the context otherwise requires, the definitions given in this chapter govern construction of this part" (emphasis added).

RTC § 23030 provides that throughout the B&CTL the definition of taxpayer generally means the separate or individual entity subject to tax in California "except where the context otherwise requires" a different interpretation. A prime example where it has been concluded that "the context otherwise requires" is in connection with the taxation of unitary businesses under RTC §§ 25101 and 25120-25139 (UDITPA).² Under those provisions, the term "taxpayer" is broadly defined to mean the unitary business and includes corporations which are not even taxable by California. The issue in *Atkinson* was whether, under the facts presented, the term "taxpayer" in RTC § 23601 should be limited to the separate corporate entity which technically incurred the expenses or should be

¹ Judgment was entered in California Superior Court case No. 987401, *Guy F. Atkinson Company of California v. Franchise Tax Board*, on September 11, 1998. A notice of appeal has been filed by the taxpayer.

² Uniform Division of Income for Tax Purposes Act.

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considered to include the unitary group of which it was a part.

Factual Background

The evidence was presented at trial through a stipulation of facts. Below is a brief summary of the more pertinent facts.

During the years in issue, Guy F. Atkinson Company of California (“Atkinson”) was engaged in a single unitary business with WBL Solar Corp. (“WBL”), Wismer & Becker Contracting Engineers (“Wismer & Becker”), Guy F. Atkinson Company, Bingham Willamette division of Guy F. Atkinson Company, Solar Power Operators division of Guy F. Atkinson Company and Luz Solar Partners, Ltd. (“Luz”).

During 1983, Wismer & Becker, a wholly owned unitary subsidiary of Atkinson, was approached by Luz International, Ltd. to construct a solar power plant in California (“solar project”). As part of its participation in the solar project, Wismer & Becker was asked to participate as an equity partner in the project. Wismer & Becker entered into a Joint Venture Agreement with Luz International, Ltd., which called for Wismer & Becker to contribute \$5 million and Luz International, Ltd. to contribute \$50,505 toward the formation of WBL.

Wismer & Becker’s \$5 million capital contribution to WBL came from a concentration account which Atkinson’s unitary group had at Bank of California. In return for the capital contribution, Wismer & Becker acquired 99 percent of the voting stock of WBL. WBL, in turn, contributed the \$5 million to Luz, a limited partnership, in exchange for a 14.482 percent general partnership interest in Luz.

The installation of the solar power plant in California was a major construction project for Atkinson’s unitary group with \$62 million in gross revenues paid to Wismer & Becker. Pursuant to a construction contract with Luz, Wismer & Becker designed, installed and constructed the solar project. Atkinson guaranteed all obligations of Wismer & Becker under the construction contract. Bingham Willamette supplied pumps for the solar project. Solar Power Operators assumed the maintenance and operations obligations of the solar project after completion. The Atkinson entities involved in the solar project accounted for more than 97 percent of the unitary group’s combined California apportionment factors in the years in issue.

In 1984 the solar power plant was installed and Luz claimed a California solar energy tax credit in respect to

the plant. As a partner in Luz, WBL’s share of the solar energy tax credit was \$1,655,489.

For the years in issue, Atkinson and its unitary subsidiaries filed their California corporation franchise tax returns on a combined report basis. Of the \$1,655,489 solar energy tax credit referenced above, Atkinson and its unitary subsidiaries reported a solar energy tax credit of \$807,172 on their unitary group return for 1984, \$282,772 for 1986 and \$282,773 for 1988.

For these years, Atkinson calculated the limitation for the solar energy tax credit based on the tax liability before credits of the unitary group. On audit, FTB’s auditor limited the utilization of the solar energy tax credit to the franchise tax liability of WBL calculated on a separate company basis—\$11,249 for 1984, \$15,082 for 1986 and \$15,723 for 1988.

Arguments of the Parties

Plaintiff’s Position

At trial, Atkinson contended that based on the facts, since the tax credit was generated by the activities of the unitary group and was not the result of a passive nonbusiness investment, the credit should be applied against the group’s California tax liability. Atkinson argued that under the circumstances presented in this case, the term “taxpayer” in RTC § 23601 must be interpreted to include the unitary group. Otherwise, drastically different tax results would occur depending upon which Atkinson unitary entity technically was the investor in the solar project.

Atkinson relied upon the State Board of Equalization’s (“SBE”) decisions in *Finnigan I* and *II*. In *Appeal of Finnigan Corporation* (SBE, 1988) (“*Finnigan I*”), the SBE, in concluding that “basic unitary theory” requires that for purposes of RTC § 25135(b)(2) and the sales factor throwback rule, the term “taxpayer” means all corporations within the unitary group, held the following:

“To hold otherwise would result in an apportionment formula which produced a *different tax effect* where the unitary business was conducted by the divisions of a single corporation than where it was conducted by multiple corporations. No difference in principle is discernible in the two situations. *The California Supreme Court has told us that as far as unitary theory is concerned the same rule should apply whether the integral parts of the unitary business are or are not separately incorporated.* (*Edison California Stores, Inc. v. McColgan*, supra, 30 Cal.2d at 473, 480.)” (Emphasis added.)

In 1990, the SBE issued its decision in *Appeal of Finnigan Corporation*, Opinion on Rehearing (SBE, 1990) (“Finnigan II”), reaffirming the conclusions reached in *Finnigan I*:

“[B]y focusing on the state’s jurisdiction to tax the seller as a separate corporate entity, *the rule elevates form over substance* by yielding a different apportionment result dependent solely on whether the unitary business is conducted by several corporations or only by one. *The teaching of Edison California Stores v. McColgan*, 30 Cal.2d 472 [183 P.2d 16] (1947), however, is that application of the unitary concept does not depend on the number of corporations which make up the business, at least in the absence of some clearly compelling consideration requiring a difference in treatment” (emphasis added).

Atkinson also relied upon FTB Notice 90-3. In Notice 90-3, the FTB, in response to the SBE’s decisions in *Finnigan I* and *II*, revised its intrastate apportionment method in situations where a member of a unitary group which is immune from California taxation makes sales into California. Under its revised method, the FTB ignores corporate lines and assigns the California property, payroll and sales of the immune entity to other members of the unitary group which are taxable in California. In effect, the California property, payroll and sales of the immune entity are considered the California property, payroll and sales of the unitary group. This in turn causes the California tax liability of the taxable members of the unitary group to *increase* by the amount of tax which would otherwise have been assigned to the exempt entity. In other words, the taxable members are being required to pay tax not only for their separate liabilities but also for the unitary group as a whole. The position taken by the FTB in Notice 90-3 was upheld in *Appeal of The Nutrasweet Company* (SBE, 1992).

Taking a page from the current dispute with the FTB regarding the netting of capital gains and losses within a unitary group, Atkinson asserted that it is a fundamental principle of unitary business and combined report concepts that unitary business expenditures by any member of a unitary group are deductible against the unitary business income of the group. Neither items of income nor expenditures of the unitary group are traced to the particular unitary member from which they were generated. *Appeal of The Signal Companies* (SBE, 1990). Atkinson asserted that in this case, the FTB was taking the position that unitary expenditures which generate a *credit* rather than a *deduction* are to be treated differently, contrary to these fundamental principles.

Atkinson pointed out that the term “taxpayer” is used in a variety of settings to mean the unitary group and not simply the separate corporate entity which is a member of that group. In addition to the sales factor in *Finnigan I* and *II* and other provisions within UDITPA, Atkinson called the court’s attention to a number of non-UDITPA examples as well, specifically RTC § 24344 (interest offset), RTC § 25101 (authority for combined reports) and RTC §§ 19104 and 19521 (hot interest). While the FTB could not seriously disagree with the above, it argued that tax credits are different.

The FTB contended that the tax credit under RTC § 23601 is limited to the specific taxpayer investing in the eligible solar energy system. However, in this case, WBL did not have, on its own, the financial ability to make the required capital contributions which generated the credit. The funds which gave rise to the solar energy tax credit did not come from any separate operations of WBL; rather they came from Atkinson’s entire unitary business operations.

Moreover, as Atkinson noted, under the FTB’s interpretation, RTC § 23601 itself would use the term “taxpayer” in at least two different ways: for purposes of claiming the *credit*, the term “taxpayer” would mean the separate entity; while for purposes of claiming a depreciation *deduction* from the *unitary group’s* business income, the term “taxpayer” would include the entire unitary group. RTC § 23601(g) provided:

“In lieu of claiming the tax credit provided by this section, the taxpayer may elect to take a depreciation [deduction] pursuant to Section 24349. Also, the taxpayer may take depreciation pursuant to that section for the cost of a solar energy system in excess of the amount of the tax credit claimed under this section.”

The FTB argued throughout the litigation that a proper application of the unitary business principle and combined report methodology does not result in a disregard of the separate corporate identities of the members of the unitary group, nor does it allow for the taxation of the unitary group as a whole. Atkinson disagreed and pointed to FTB Notice 90-3 and *Nutrasweet* which arrive at precisely such a result. Atkinson argued that there is no relevant distinction between the result reached in FTB Notice 90-3 and *Nutrasweet* and the taxation of the unitary group as a whole. Atkinson asserted that the FTB can not have it both ways. If the SBE’s decisions in *Finnigan I* and *II* provide the basis for ignoring the separate corporate identities of exempt unitary members as set forth in FTB Notice 90-3 and *Nutrasweet*,

then there is no sound rationale for limiting the credit herein to a single member of Atkinson's unitary group, especially where the funds used to invest in the solar power facility came from the operations of the entire Atkinson unitary group.

Alternatively, Atkinson contended that since the tax credit was generated by its unitary business operations it should be apportioned to each taxpayer member of the unitary group by use of the intrastate apportionment methodology. The FTB countered that "tax credits cannot be controlled by the apportionment provisions." However, the FTB's position appears to be directly contrary to the FTB's Legal Ruling 95-2 and the decisions of the United States District Court in *First Pacific Bancorp, Inc. v. State of California Franchise Tax Board*, No. CV 961910 JGD(CTx) and the SBE in *Appeal of First Pacific Bancorp* (SBE, 1995). Legal Ruling 95-2 and the *First Pacific Bancorp* decisions involve the issue of determining which unitary entity in a combined report is entitled to a tax refund. The FTB utilizes intrastate apportionment of the tax payments to make this determination.

There appears to be no substantive difference between an intrastate apportionment of a tax refund and an intrastate apportionment of a tax credit. In both instances, it is the tax which is being apportioned, not simply the income. If it is permissible with respect to tax refunds, it would appear to be permissible with respect to tax credits.

The use of intrastate apportionment concerning tax credits is logical and finds support in the FTB's Multistate Audit Technique Manual ("MATM"), 1986 § 0226:

"Intrastate apportionment is the process of determining, for each California taxpayer in a combined group, that corporation's *individual tax liability*" (emphasis added).

Similarly, intrastate apportionment of tax credits finds support in *Appeal of Joyce, Inc.* (SBE, 1966) where the SBE stated:

"Accordingly, when two or more entities conduct a portion of a unitary business in this state, it is necessary, after the portion of the income from unitary business attributable to the state is determined to make a *further apportionment* between the entities of the group to *determine the tax liability* of each. In many instances the apportionment between the taxpayers within the state is unimportant since the *tax* in total amount is the same, and the persons in control of the unitary business are not economically affected by the method of, or lack of, that apportionment" (emphasis added).

In this case, intrastate apportionment of the tax credit appears to be a reasonable result since the credit would be spread among the entities in the Atkinson unitary group which participated in the solar project and which, in turn, accounted for nearly 100 percent of the unitary group's presence in California. Further, apportioning the credit among the members of the unitary group flows directly from the teachings of *Edison* and *Finnigan I and II* since it avoids producing a "different tax effect" simply because Atkinson's unitary business was conducted by multiple corporations rather than a single corporation with multiple divisions.

To further bolster its arguments, Atkinson relied upon RTC § 25137 as giving the court authority to correct the unfair results caused by the FTB's action in the instant case. As previously noted, intrastate *apportionment* principles are used by the FTB to determine the respective tax liabilities of the members of the unitary group. MATM § 0226; *Joyce*. Intrastate apportionment is also used to determine the proper application of tax payments and tax refunds within a unitary group. FTB Legal Ruling 95-2. Atkinson argued that if, as in this case, the FTB's application of these *apportionment* principles causes an unfair result or a "different tax effect," solely because of corporate lines (*Finnigan I*), then RTC § 25137 provides the authority to remedy the situation. RTC § 25137 is intended to correct unfair allocation and *apportionment*. While the FTB contended that RTC § 25137 can only be used to correct unfair computations of income, Atkinson asserted that it is nonsensical to limit the scope of RTC § 25137 to the computation of income and at the same time ignore the computation of the tax liability arising therefrom.³

Defendant's Position

The FTB relied heavily on three arguments: (1) the burden of proof was on the taxpayer and it had not been sustained; (2) tax credits, similar to deductions and exemptions, are to be construed narrowly against a taxpayer; (3) the legislative history of RTC § 23601.

With respect to the legislative history, the FTB argued that prior to 1978, RTC § 23601 would have allowed a

³ In this case, Atkinson's liability for 1984 alone was 200 times higher under the FTB's methodology than it would be if the tax credit was applied as proposed by Atkinson—a grossly distorted result under any definition. See, e.g., *Hans Rees' & Sons, Inc. v. North Carolina ex rel Maxwell*, 283 U.S. 123, 134 (1931) (state tax struck down as being grossly distorted where the tax liability produced under the state's apportionment methodology was 3.5 times higher than the court believed was reasonable).

unitary group to be treated as a single taxpayer. However, a 1978 amendment deleted those provisions, and therefore the credit could not be utilized in the manner sought by Atkinson.

Atkinson countered by referring to the same legislative history and noted that prior to the 1978 amendment only one credit could be claimed by two or more unitary corporations which had *each installed* a solar system. Atkinson argued that the 1978 amendment which removed these restrictions should be viewed as supporting its position and not the FTB's, since, under the prior law, only WBL could have claimed the credit.

Trial Court's Ruling

The trial court rejected Atkinson's arguments and concluded that the credit could only be claimed by WBL. The court did not attempt to reconcile the multiple uses of the term "taxpayer." Instead, it fell back on the three principal arguments of the FTB—burden of proof; narrow construction; and prior legislative history. As Atkinson has now filed a notice of appeal, it remains to be seen whether the trial court's holdings will be sustained on appeal. Stay tuned.

Interest Offset Survives Round Two

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On December 11, 1998, in a pair of unpublished opinions,¹ the First District of the California Court of Appeal upheld the constitutionality of California's controversial interest offset rule. In *Hunt-Wesson, Inc. v. Franchise Tax Board*, No. A079967, and *F. W. Woolworth Company, et al. v. Franchise Tax Board*, No. A075506, the Court of Appeal rejected the taxpayers' arguments that California Revenue and Taxation Code Section 24344 was unconstitutional under Commerce, Due Process and Equal Protection Clauses of the United States Constitution. The Court of Appeal relied heavily on the

doctrine of *stare decisis* and the California Supreme Court's decision in *Pacific Tel. & Tel. Co. v. Franchise Tax Board*, 7 Cal.3d 544 (1972). In so ruling, the Court of Appeal reversed the trial court in *Hunt-Wesson* and affirmed the trial court in *Woolworth*.²

Those who have filed claims for refund challenging the interest offset rule should not discard those claims quite yet. A petition for review most likely will be filed with the California Supreme Court by one or both of the taxpayers. While review is discretionary, it will be interesting to see whether the current California Supreme Court agrees with the Court of Appeal's interpretation of the 1972 California Supreme Court's decision in *Pacific Telephone*.

A copy of this article can also be found as part of the firm's Tax Page on the world wide web at <http://www.pmstax.com/state/intoff9812.html>.

¹ In California, unpublished opinions are not precedential and cannot be cited or relied on by a court or party in any other action or proceeding. California Rule of Court 977(a).

² In *Woolworth*, the Court of Appeal also affirmed the trial court's decision in favor of the Franchise Tax Board, that during the years in issue, Woolworth and Kinney Shoes were not conducting a unitary business.