

Reproduced with permission from Tax Management Weekly State Tax Report, Volume: 20 Issue: 45, 11/08/2013. Copyright © 2013 by The Bureau of National Affairs, Inc. (800-372-1033) <http://www.bna.com>

Tax Policy

Criss-crossing the country, Crowell & Moring's state tax team meets regularly with state tax commissioners and their counsel to bring Bloomberg BNA's readers candid and timely observations from the country's top state tax decision-makers. Eight stops into this 50-state journey, Don Griswold, Walt Nagel, and Jeremy Abrams spoke this month with Jozel Brunett, California Franchise Tax Board's Chief Counsel. In this interview, Brunett discusses high profile FTB litigation, her role in California's settlement program, and the ins and outs of Proposition 26 and ballot initiatives for state taxes.

Crowell's Conversations: An Interview With Jozel Brunett, California Franchise Tax Board Chief Counsel

JOZEL BRUNETT, INTERVIEWED BY DON GRISWOLD,
WALT NAGEL AND JEREMY ABRAMS

Interested Parties

CROWELL: We're here in San Francisco at Crowell's 27th annual "Managing Tax Audits" seminar where just a few moments ago you discussed several recent California tax developments. Among them, the upcoming Interested Parties Meeting (IPM) in Sacramento dealing with the new market-based sourcing regulations for "sales other than sales of tangible personal property." What specific issues has market-based sourcing presented?

Jozel Brunett is Chief Counsel at California's Franchise Tax Board. Messrs. Griswold, Nagel, and Abrams are attorneys with Crowell & Moring LLP and can be reached at dgriswold@crowell.com, wnagel@crowell.com, and jabrums@crowell.com. For more information about Crowell's state tax practice, visit www.crowell.com/statetax.

BRUNETT: Taxpayer feedback has been generally positive regarding the regulations issued under the new services and intangibles provision. The most frequent request is for guidance on the reasonable approximation rule for sales of services where one business sells a service to another business. We also have areas where the original regulations were silent, and we received questions on those areas as well. For instance, the proper assignment rule for services provided to the federal government. Currently, we have no regulatory guidance on how to assign receipts from a federal government contract. We're also getting lots of inquiries from the financial services industry regarding sales of marketable securities. This is the focus of the current regulatory effort.

CROWELL: What changes or additions, if any, do you anticipate being made to the proposed regulations?

BRUNETT: Amendments that are currently being discussed with taxpayers in relation to the Oct. 18th IPM include five big items. First, a definition for "marketable securities" including a stand-alone definition for broker-dealers so they can differentiate whether their sales of intangibles fall under the "marketable securities" rules or the sale of stock rules. We're also discussing rules for assigning "marketable securities" to the location of the customer—billing address for individu-

als, commercial domicile for businesses, or “reasonable approximations.” Another topic is the assignment of receipts for dividends, interest, and goodwill; assignment here will follow the sale of stock rules. We’re also dealing with reasonable approximation for assigning the sale of an interest in a corporation or pass-through entity where the taxpayer does not have access to the factor information of the underlying corporation. Assignment of asset management fees is also an issue; this will be similar to the provisions for mutual fund providers under §25137-14. We will undertake a future regulatory effort on the government sales issue; it is simply beyond the scope of the current effort.

CROWELL: The Interested Parties Meetings process is very good. What do you hope to accomplish through this process in general, and what other measures do you take to help you fairly interpret the law and guide the FTB?

BRUNETT: The FTB has become more transparent in how it does business, and has worked to enhance our customer service experience. IPMs are a great way to get input from taxpayers and their representatives. Sometimes there are conflicting views, and we cannot always draft the language to meet everyone’s concerns, but our goal is to listen and give due consideration to comments that we receive. We issue a Notice every year in November, inviting public comment on recommendations for items that should be included on the Rulemaking Calendar for the next year.

“We are projecting Fall of 2014 for oral arguments [in *Gillette*]”

We’ve been holding IPMs on regulatory matters for a while. But now we are also starting to hold IPMs on non-regulatory matters, such as the Research and Development Credit IPM (October 2012) and the Tribal Leaders Consultation Session and Interested Parties meeting (September 2013). On the R&D IPM, we opened dialogue with practitioners and taxpayers on issues related to the California research credit including best audit practices, and possible legislation fixes.

California Tax Litigation

CROWELL: The FTB recently filed its reply brief in *Gillette*—the Compact election litigation. What do you think will be some of the key factors the Court will rely on in deciding this case?

BRUNETT: We hope that the Court recognizes the unique nature of the Multistate Tax Compact and takes into account the conduct of the member states in interpreting the Compact in reaching its decision. Ben Miller, who is working with us as a retired annuitant is working the Amicus Brief portion for us; he’s helping us out. We are projecting Fall of 2014 for oral arguments, so it may be a while before the Court issues its opinion.

CROWELL: Speaking of elections, for tax years 2011 and 2012, California taxpayers could make an election to apportion income using a single sales factor. Did California see revenue go way down in those years as a

result of allowing taxpayers to choose the formula that results in the least amount of tax?

BRUNETT: We did. For fiscal years 2011-2013, we originally estimated a \$1.8 billion revenue loss. We’ve revised that to \$2.2 billion. Once we are able to compile all of the tax return data, the actual impacts could differ substantially. The Prop 39 benefit estimate, on the other hand, is positive: \$355 million in FY 12/13.

CROWELL: Let’s talk about the *Cutler* decision. It certainly seemed very clear under *Ceridian* and *Farmer Bros.* precedent that this law was unconstitutional. In that type of situation—when you know a law is invalid—is there really nothing the FTB can do except kick the can down the road for the courts to decide?

BRUNETT: Yes. Article 3 section 3.5 of the state constitution requires that a state agency apply the law until a court of appeal holds the law is unconstitutional. We defended the law at issue in *Cutler* and we were successful in the trial court. Unfortunately, the court of appeal overturned the trial court decision and held the law unconstitutional.

CROWELL: Gov. Brown recently signed A.B. 1412, in response to the *Cutler* decision, providing some relief to investors that benefitted from the discriminatory law. We were pleased to see this, particularly since we had a hand in arguing that case. The great thing about this success story is how quickly relief was passed. How did this situation differ from the situation following *Ceridian* and *Farmer Bros.* where it took eons to find a resolution, and is this promptness a bellwether indicator of things to come?

BRUNETT: Yes, the Legislature did act promptly in this matter. As to legislative efforts, after the *Ceridian* decision in 2000, there was a legislative effort to deal with the unconstitutional law, similar to what happened after *Cutler*. The result was that in 2004, A.B. 263 was enacted. This legislation created a new, nondiscriminatory DRD for dividends received from insurance companies as well as other rules related to insurance company subsidiaries. In contrast, no such legislative effort took place after the *Farmer Bros.* decision.

CROWELL: What other important cases are in the litigation pipeline?

BRUNETT: We have several cases ongoing. In the business/non-business income and unitary business area, we have *Comcon Production Services I v. FTB*, which involves our determination that a \$1.5 billion merger poison pill constituted business income under the “transactional test,” and that Comcast was unitary with its 57-percent owned subsidiary, QVC, due to flows of value and contribution and dependency between the two businesses. We’re currently in the middle of trial.

We also have a couple cases where the taxpayers claim the LLC fee is facially unconstitutional: *Bakersfield Mall* and *CA-Centerside II*. Both cases also seek permission to proceed on a class action basis, notwithstanding the fact that both plaintiffs admit that they did not file a claim for refund on behalf of taxpayers other than themselves. Plaintiffs’ motion for class action certification was heard on Oct. 7, 2013 and indications are that the court will be ruling in our favor denying the motion.

CROWELL: What is your role in advising the Attorney General’s office in these litigation matters?

BRUNETT: In all of our litigation cases, we enjoy a collaborative working relationship with the AG's office. By statute, the AG represents us in court. So they are the ones taking the depositions and making the court appearances. We work closely with them to draft pleadings, briefs, and motions. We assist with developing discovery requests and responding to discovery. We provide input on the substantive arguments and assist in gathering evidence to be used in the litigation.

We recently reorganized the Legal Division to include a new bureau which is our "Litigation Bureau." The head of that bureau, Bill Hilson, has extensive private practice litigation experience before coming to work for the Franchise Tax Board. Our goal is to mentor and train attorneys in their litigation skills so they can provide the AG's office with even better support in their handling of our cases.

Administrative Settlements

CROWELL: Tell us about your role in California's settlement program and in settling cases once the AG is litigating them in the courts.

BRUNETT: We have an administrative settlement program at FTB. Under the statute, we are authorized to settle tax matters in dispute that are the subject of protests, administrative appeals, or refund claims. For litigation cases, the AG's office represents us in the settlement negotiations, but as we are the client, we are responsible for the settlement authority and we routinely attend the settlement conferences as the client representative.

CROWELL: When the FTB brings audit challenges, how does it distinguish between structures that may have been created for tax-avoidance purposes, and structures created for legitimate business purposes that incidentally have a tax benefit? Many of us think the pendulum has swung too far in the direction of governmental mistrust of taxpayers. Do you think states have gone too far?

BRUNETT: Identifying tax avoidance structures involves an in-depth analysis of the facts of the individual case. If, however, the structure is a known tax avoidance structure and has been identified as such by the FTB or the IRS, then the taxpayer is required to identify the structure on the tax return. But they're out there, and we're working on obviously recognizing those transactions that are shelters and those that are legitimate, and understanding that there is a distinction.

CROWELL: Do you think there may be a way to bring a little more discipline to the process of thinking about what really should be considered shelters and what should be respected? Can government and industry work better together to repair this environment of suspicion between taxpayers and administrators?

BRUNETT: Yes. Now and then we have those conversations with our team. We are partnering with our auditors more at the audit level stage, too, and they will call our attorneys who handle shelter issues when those cases come in and say "this is what we're seeing, what do you think?"

Empty NEST

CROWELL: We've got a long way to go on this, and some rather extreme penalty provisions aren't helping matters!

BRUNETT: We have substantial penalties we can apply if something is an abusive tax avoidance transaction, including the non-economic substance transaction (NEST) penalty. But we have chief counsel relief from the NEST penalty as well. If a taxpayer wants to contest the NEST penalty, they protest it in addition to the underlying assessment. They file a form asking for chief counsel relief and the protest hearing officer will work up the case as you would a normal protest. Currently all the tax shelter cases are handled in the Legal Division so when it gets time to determine what to do about the penalty, the staff person, after reviewing the protest and getting all the information, documentation, etc., will give me a recommendation about what to do with the penalty. I consider that recommendation and determine whether to sustain it, whether to partially modify it, or whether to withdraw it.

Relief from the NEST penalty is a unique animal because there is no right to appeal from my decision. However, if we sustain the penalty and the taxpayer appeals to the Board of Equalization, the BOE can still look at the substance of the transaction—whether there was a business purpose or economic substance. I focus more on equitable factors—did the taxpayer rely on an adviser, was it something they purchased with a tax opinion, that sort of thing. So we're really trying to work within the rules to preserve taxpayers' due process rights. Our aim is to encourage voluntary compliance by creating the perception and reality of fairness.

“[Using contingent-fee contract auditors] doesn't seem ethical to me”

CROWELL: Do you think the government has an ethical obligation to collect the correct amount of tax under the law, rather than the most dollars it can get from a taxpayer?

BRUNETT: You've hit the nail on the head. This is what's a little bit different about government practice. You know, you're not out to get the most that you can for your client. You're out to get to the right result. And if the right result means you settle for X-amount or you withdraw an assessment because the law is clear that it should be withdrawn or modified, that's what we do. I think we have a higher duty.

CROWELL: Some states, mostly in the unclaimed property space but also for transfer-pricing audits, have been using third-party, contract auditors—we call them bounty hunters—who are compensated under a contingent-fee arrangement. Do you think California would ever go that route?

BRUNETT: No, I don't think so. That would be inconsistent with our higher duty to get the right result. It doesn't seem ethical to me.

Tax Reform

CROWELL: Do you believe the conditions are right for California to enact tax reforms aimed at removing some of the complexities in the state's tax system?

BRUNETT: In the absence of federal tax reform, efforts to remove some of the complexities or anomalies in California tax law have become more complicated by

the adoption of Proposition 26 in 2010. This constitutional amendment requires the approval of two-thirds of the legislature for any legislation that increases the taxes paid by any one taxpayer. In the past, tax reform efforts were often accomplished with revenue-neutral measures. This new constitutional requirement can be expected to diminish the likelihood of many tax reform proposals.

In addition, I can't opine on what types of tax reform might be appropriate, as we are charged with administering the law once it is enacted, but to the extent legislation is enacted which simplifies rules for taxpayers, and makes it easier for them to meet their filing obligations, that is a worthy goal.

CROWELL: Does the FTB hold much influence in the California Assembly? Does party control affect the FTB's influence?

BRUNETT: That's an interesting question, which is probably best answered by members of the Assembly, chairs of various Assembly committees, and their respective staff members. FTB provides the legislature with an analysis of any legislation that impacts the laws it administers. These analyses are available on FTB's website.¹

BRUNETT: Upon request, FTB staff does provide assistance to legislators and committees to craft legislation and amendments to resolve issues that may have been identified. While FTB staff can and often does identify alternative solutions to address concerns, tax policy recommendations are reserved to the three-member Franchise Tax Board, consisting of the State Controller, the Director of the Department of Finance, and the Chair of the State Board of Equalization. In recent years, the Board, as a body, has not taken a position on pending legislation. However, individual Board members may take positions on pending bills.

Proposition 26 and Ballot Initiatives

CROWELL: You mentioned the two-thirds super majority rule of Proposition 26. Was the 2010 federal tax conformity law (S.B. 401) valid under Prop. 26?

BRUNETT: Yes, that continues to be FTB's position. As we explained in Legal Division Guidance 2011-0101, FTB is required by the Constitution to enforce S.B. 401 until an appellate court has made a determination that some portion or all of S.B. 401 is 'void' pursuant to Proposition 26 and, therefore, unenforceable.

CROWELL: How does the Proposition/ballot initiative process work in California with respect to tax laws?

BRUNETT: There are no special rules for statewide ballot measures involving taxes.

There are two ways a measure can be placed on the ballot, and these apply to tax measures, too. First, the Legislature has the ability to place constitutional amendments, bond measures, and proposed changes in law on the ballot. Second, any California voter can put an initiative or a referendum on the ballot by following the "How to Qualify an Initiative" process. A statewide ballot measure can be approved by a majority vote of the people. Certain local ballot measures require approval by a 55-percent or a two-thirds vote of the electorate.

¹ EDITOR'S NOTE: See <https://www.ftb.ca.gov/law/legis>.

CROWELL: How does the FTB interpret legislative history for a tax law that began as a ballot initiative by a concerned resident?

BRUNETT: Courts have looked to various sources of legislative history for interpreting the provisions of ballot initiatives, including a description of the measure in voter pamphlets and other relevant materials. The California Supreme Court's 2009 decision in *Strauss v. Horton*—upholding the Prop. 8 marriage amendment—is instructive.

Litigation Skills Put to Good Use

CROWELL: We haven't talked much about you yet, Joel. Tell us a little about your pre-FTB private business litigation career, and how it helped prepare you for your current role.

BRUNETT: I worked at a business litigation law firm for seven years practicing in the field of insurance coverage law before making a career change and coming to work for the California Franchise Tax Board. My private practice litigation experience was very helpful from a number of vantage points. I learned the nuts and bolts of litigation, from discovery through trial. I had an extensive law and motion practice where I was able to hone my writing and oral argument skills. During my time in private practice, I also had the good fortune to argue two cases before the California Court of Appeal. All of this was very helpful in terms of preparing me for my role as a tax attorney at the FTB. At FTB, my litigation skills were recognized and put to good use both in terms of assisting the AG with litigation and in handling a very heavy caseload of administrative appeals before the State Board of Equalization.

Changes at the FTB

CROWELL: What has changed most about the FTB, and about California tax litigation in general, in the 20 years since you joined?

BRUNETT: The most changes at FTB have been in the area of technology. The majority of tax returns are now filed electronically. Taxpayers are also increasingly paying their tax obligations electronically. We have a multitude of e-service options available to taxpayers, and we are in the middle of a large IT project that will provide even more online taxpayer services, to be completed in December 2015. FTB has also become more transparent in how we do business. We have published more materials online to assist with taxpayer education and to inform the public regarding FTB positions. Examples are Chief Counsel Rulings, Notices, and redacted technical advice memoranda that are available on our website. We are a customer service oriented department that has continued to evolve.

**"We are a customer service oriented department
that has continued to evolve"**

In terms of the tax practice, it has definitely gotten more sophisticated and complex over the years. At the same time, as government attorneys, we have had to learn to do more with less. We have had furloughs, hir-

ing freezes, and have lost positions. We have learned to streamline and improve our processes. In recent years, we have been able to attract a wide variety of both experienced and new attorneys with advanced taxation degrees, which have contributed to fresh perspectives on how we do our work. Through it all, our number one goal is to be fair and get to the correct amount of tax. Like I said earlier, if that means withdrawing or modifying an assessment, that is what we will do. That part has not changed.

CROWELL: What is the best part of your job?

BRUNETT: The best part of my job is the people with whom I have the privilege of working. I have an extremely talented management team and group of attorneys and support staff who work hard and whose aim is to do the right thing by arriving at the correct amount of tax, and to provide the best customer service in reaching that result. We've survived some tough times together, and everyone pitches in when somebody needs help. I feel like I have a family of about 100 people. You can't ask for a better job than that.

CROWELL: And we couldn't have asked for a better interview, Jozel. Thanks so much.