

AN ALERT FROM THE BDO STATE AND LOCAL TAX PRACTICE

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## SALT

### SUBJECT

## THE CALIFORNIA COURT OF APPEALS, 4TH APPELLATE DISTRICT HELD THAT CALIFORNIA'S COMBINED REPORTING SCHEME VIOLATES THE COMMERCE CLAUSE

### SUMMARY

On May 28, 2015, the California Court of Appeals, 4<sup>th</sup> Appellate District issued its decision in *Harley-Davidson, Inc. v. California Franchise Tax Board*, No. D064241 (Cal. Ct. App. May 28, 2015), in which it held that California's combined reporting scheme, which allows an intrastate group of unitary corporations to elect to file on a separate company or combined basis but requires an interstate group of unitary corporations to file on a combined basis, violates the Commerce Clause of the United States Constitution. The court also held that two of the taxpayer's financial services subsidiaries had Due Process Clause and Commerce Clause nexus with the state even though each subsidiary did not purposefully target the California market or have a physical presence in California on its own.

### DETAILS

#### BACKGROUND

Harley-Davidson, Inc. ("Harley-Davidson") is a Wisconsin headquartered corporation that engages in two businesses through several subsidiaries: (1) a motorcycle business and (2) a financial services business. Among the subsidiaries that comprise the financial services business are Harley-Davidson Customer Funding Corp. ("HDCF") and Eaglemark Customer Funding Corp. IV ("Eaglemark"). Each purchased loans secured by motorcycles, some of which originated in California, from Harley-Davidson Credit Corporation ("HDCC"), which is also a Harley-Davidson financial services subsidiary. HDCF and Eaglemark then "securitized" the loans they purchased through trusts they each owned.

HDCF and Eaglemark each had no employees and so they entered into contracts with HDCC to service the loans they owned through the trusts. HDCC, which had offices in Nevada and other states but no property or employees in California, had its Nevada based employees perform collection activities with respect to delinquent loans. In the event of an unsuccessful collection, HDCC hired a third-party to repossess the motorcycle. An HDCC employee visited an



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auction house in California on 17 days total to assist with setting prices for repossessed motorcycles at auction or to observe some part of the auction process. HDCF and Eaglemark had no control over how the loans it purchased were obtained and neither entity specifically targeted any state, including California, as it did not matter to either entity where the underlying borrower was located.

For the taxable years at issue, Harley-Davidson filed combined returns with California that included the motorcycle business only. Upon audit, the California Franchise Tax Board (the “FTB”) concluded that the financial services business should have been included in the combined report and assessed additional taxes. Harley-Davidson paid provisional taxes in excess of \$1.8 million and then filed suit against the FTB in the Superior Court of San Diego County for an income tax refund claiming: (1) California’s combined reporting scheme violates the Commerce Clause; and (2) HDCF and Eaglemark do not have nexus with California. The Board filed a demurrer<sup>1</sup> with respect to each claim, which the Superior Court sustained, and Harley-Davidson timely appealed to the California Court of Appeals.

### **CALIFORNIA’S COMBINED REPORTING SCHEME VIOLATES THE COMMERCE CLAUSE**

The court in *Harley-Davidson, Inc.*, had three questions before it with respect to California’s combined reporting scheme: (1) whether California’s combined reporting scheme treats interstate and intrastate businesses differently; (2) whether any differential treatment discriminates against interstate commerce; and (3) whether any differential treatment withstands strict scrutiny.

The FTB conceded that California’s combined reporting scheme treats interstate and intrastate businesses differently and the court remanded the strict scrutiny question for the trial court to make a determination because the FTB had raised the issue for the first time on appeal. With respect to the discrimination issue, the court held that Harley-Davidson had sufficiently alleged discriminatory treatment in violation of the Commerce Clause of the U.S. Constitution for purposes of surviving the demurrer challenge. The Court of Appeals directed the Superior Court to enter an order overruling the demurrer as to that claim and to conduct further proceedings consistent with its opinion.

With respect to its discrimination holding, the Court of Appeals reasoned that the holdings in *Fulton Corp. v. Faulkner*, 516 U.S. 325 (1996), *South Central Bell Telephone Co. v. Alabama*, 526 U.S. 160 (1999), *Farmer Bros. Co. v. Franchise Tax Board*, 108 Cal. App. 4th 976 (2003), and other case precedent lead to the unavoidable conclusion that California’s combined reporting scheme facially discriminates against interstate commerce in violation of the Commerce Clause because whether a unitary business computes its California tax liability using the separate company or combined reporting method is determined solely by where the unitary business is engaged in business. The court wholly rejected all of the FTB’s arguments, including an argument that the present combined reporting scheme is justified because it is an attempt to “level the field” between interstate and intrastate businesses.

### **HDCF AND EAGLEMARK HAVE NEXUS WITH CALIFORNIA**

Under the Due Process Clause of the U.S. Constitution, a state may not impose a tax unless the taxpayer has “minimum contacts” with the state such that the maintenance of a lawsuit does not offend traditional notions of fair play and substantial justice. Under the Commerce Clause of the U.S. Constitution, a state may not tax a taxpayer unless it has a “substantial nexus” with the state, which may be satisfied by a physical presence in the taxing state, whether by the taxpayer itself or an independent contractor or an agent in the state acting on the taxpayer’s behalf.

The court in *Harley-Davidson, Inc.*, held that HDCF and Eaglemark had the requisite “minimum contacts” and “substantial nexus” with the state for California to impose an income tax and, thus, affirmed the Superior Court’s decision as to this issue. The court reasoned that there was sufficient evidence, based on conduct and circumstances, to support an agency relationship between HDCC and HDCF and Eaglemark, and HDCC carried on collection and auction activities in California on their behalf. The court rejected Harley-Davidson’s arguments, including the following: (1) the decision in *Borders Online v. State Board of Equalization*, 129 Cal. App. 4th 1179 (2005) demands a more stringent three or four-prong agency relationship test; (2) HDCF and Eaglemark did not purposefully target the California market as this was done through their agent, HDCC; (3) an agent’s in-state activity must be sales-related to create nexus; and (4) HDCC’s in-state activity was de minimis.

<sup>1</sup> A demurrer is a pleading stating that although the facts alleged in a complaint may be true, they are insufficient for the plaintiff to state a claim for relief. *Black’s Law Dictionary* 444 (7<sup>th</sup> ed. 1999).

## BDO INSIGHTS

- ▶ Given that California's combined reporting scheme is at stake, it is very likely that this matter is far from over. But note that even if the court ultimately finds that the combined reporting scheme cannot survive a strict scrutiny challenge (i.e., the state has a legitimate interest in the differential treatment that could not be accomplished in a less discriminatory manner), California may choose to cure any constitutional infirmity by requiring all corporations - interstate and intrastate alike - to file on a combined basis. Regardless, in order to preserve refund rights which may otherwise expire, pending litigation of this matter, taxpayers may want to consider filing protective refund claims in the event of a taxpayer favorable outcome.
- ▶ The decision as it relates to nexus seems to follow long-standing Due Process and Commerce Clause jurisprudence - a taxpayer generally may not contract away nexus by entering into an agreement with another taxpayer to perform an in-state activity on its behalf.

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