

- Speaker 1: This podcast episode reflects the opinions of the hosts and guests and not of Greenberg Traurig, LLP. This episode is presented for informational purposes only, and it is not intended to be construed or used as general legal advice nor a solicitation of any type.
- Shail Shah: Governor comes out earlier this week and says, "Well, actually, we're not at a deficit anymore. We actually have a surplus, and we're doing much better than expected." So like I said, it is always a roller coaster here in California with everything including our budget.
- Nikki Dobay: [00:00:30] Hello and welcome to Gettin' SALTy, a state and local tax policy podcast hosted by Greenberg Traurig. My name is Nikki Dobay, shareholder in the Portland, Oregon and Sacramento, California offices. It is 2025 and we are back. So Happy New Year. And on this episode, very pleased to be joined by one of my GT colleagues, Shail Shah, a shareholder in the San Francisco, California [00:01:00] office. Thank you so much for being here once again.
- Shail Shah: Thanks, Nikki. Happy to be back.
- Nikki Dobay: And we figured it couldn't hurt to start off 2025 with a little or big California update. Everybody's always trying to figure out what the heck is going on in California, and it seems like there's always something going on. So I feel like the prior legislative session just ended and now they're back in session and we're gearing up again. So can you catch us up a little [00:01:30] bit on kind of where we're at, big picture in California right now?
- Shail Shah: Yeah, I always like to say California has always been a boomer bus state, the gold rush, kind of think about everything else. And we were just about a year ago at a point where the sky was falling, we had a huge budget deficit, government employees were furloughed, there was this travel restriction because there was no money for government folks to travel anywhere. [00:02:00] Governor comes out earlier this week and says, "Well, actually, we're not at a deficit anymore. We actually have a surplus and we're doing much better than expected." So like I said, it is always a roller coaster here in California with everything including our budget.
- Nikki Dobay: So California always confuses me because most states have a two-year budget, but every year it seems like we're talking about the budget in California. And so the governor came out and spoke and he kind of said what he's been saying the last few years, which is [00:02:30] that he's not going to raise taxes. But from your perspective, does that have a lot of meaning?
- Shail Shah: It doesn't. I think there's a couple of things at play. Everyone knows that Gavin Newsom, our governor of California, has eyes set on something greater than California, and I think he's, over the last few years, positioned himself to say things that sort of appease moderates, appease some Republicans, and [00:03:00] quite frankly, probably upset some Democrats, but to take a middle

ground. So he did say no new taxes. And look, quite frankly, that may be right on the periphery where he may not raise rates, he may not necessarily introduce new taxes, but we all know, and I think a lot of the folks listening to this podcast know that there are a lot of different ways that taxes could be raised. When you think about what happened with the Microsoft decision and somehow disallowing a certain amount or changing the apportionment [00:03:30] factor for corporate taxpayers or disallowing deductions or limiting the use of losses or attributes, all of those are sort of indirect ways of increasing taxes. And it's very unclear whether those are off the table. And my guess is they're probably not off the table.

Nikki Dobay: Yeah. So maybe let's flip back to that 2024 budget. When we saw the apportionment changes, and I think we'll probably come back to that because we've got a few litigation updates to provide. So [00:04:00] part of the 2024 budget in a very kind of under the radar, although people knew it was happening, but there was no transparency as to what specifically was happening, we saw massive changes to the apportionment formula in California, the sales factor formula. And we saw limits put on credits and NOLs, and there was also an effort to get those limitations on the credits and NOLs to be released if we [00:04:30] found ourselves in this surplus situation. And those were all rejected. If you're crystal balling it, do you see any changes to those limitations or do you think that kind of ship has sailed and that maybe is what's saving the day, but we're not going to turn the ship around at this point?

Shail Shah: Well, there was the last minute provision that was added to the bill that if the Department of Finance and the legislature jointly agreed [00:05:00] that the state was in, I guess, a good fiscal position-

Nikki Dobay: Okay. Probably not defined.

Shail Shah: Not defined. So it's a little unclear that the limitations could be released early.

Nikki Dobay: Okay.

Shail Shah: I haven't heard. Again, there is no threshold. There's no magic number. So it's a little unclear what a good fiscal position means. But look, I mean, if the governor is signaling that everything is sort of sunshine and rosy here in California, [00:05:30] potentially they could lift those limitations.

Nikki Dobay: Okay. So we don't think there'll be any major new broad-based taxes, but there could be a lot of kind of tweaking around the edges, which is what we saw last year. And those tweaks were pretty impactful in increasing taxpayer liability. I also expect that we're going to just see some other crazy ideas come out of the legislature. [00:06:00] Hopefully we don't see these targeted ... I don't even want to say the names of them to give anybody ideas, but I guess we always need to be ... Where I'm going is we always need to be on alert when it comes to California.

Shail Shah: Yeah, I mean, look, the positive, and I mentioned this before, is that it appears the governor has eyes on something greater than California. So historically, there's a lot of legislators who have introduced, [00:06:30] as you said, all sorts of crazy bills and they're off the wall sort of bills. But by the time it gets through, the assembly gets through the Senate, things get moderated. And the fact that the governor is thinking, "Hey, look, I want to take a little bit more of a moderate position if I have aspirations for some sort of a national office," it seems highly unlikely that any of those would pass. At least the crazy stuff. But again, as you mentioned [00:07:00] on the periphery, a lot could happen.

Nikki Dobay: All right, that's just the teaser. I'm sure we'll be back talking about that more. Before we jump into a couple of regulatory items, let's hit on some of the significant litigation updates. And here I'm thinking of the two challenges to the 2024 budget apportionment provisions. So can you give us high level overview of what's going on with those cases?

Shail Shah: Yeah, so as I think [00:07:30] everybody on this podcast probably knows sort ad nauseum that there's two decisions that came out of the Office of Tax Appeal, the Microsoft decision, the Minnesota Beet Sugar decision. Both of those decisions allowed taxpayers effectively to include gross receipts in their apportionment, their sales factor that related to the deductible income. The budget bill, trailer bill or the budget bill that came out last year put in a statutory provision that disallowed the inclusion [00:08:00] of these receipts in the sales factor if they related to deductible, exempt and sort of a laundry list of items that are excluded from income.

The biggest issue with that statute is it applied on a retroactive basis. So effectively overturned these two decisions and overturned decades of precedent in California. And two organizations are challenging the validity of that statute. There's the National Taxpayers Union and [00:08:30] then there's the California Taxpayers Association. Both of those plaintiffs, at least the common challenge is that the retroactivity violates both the US and the California Constitution.

There are other issues. National Taxpayers Union also argues that the statute is unconstitutionally vague because if you look at the language itself, there are clear inconsistencies with the statute. So it is very unclear how a taxpayer would apply that statute. [00:09:00] California Taxpayers Association also argues violation of separation of powers, I think was what they call the single issue clause, a few other items, but again, these are challenges to the validity of that statute. The National Taxpayers Union is currently in the Sacramento Superior Court. CalTax's case is currently in Fresno Superior Court. In terms of timing, I think both parties are going through discovery right now [00:09:30] and a trial date has been set for CalTax and a trial date will be set for National Taxpayers Union probably pretty soon.

Nikki Dobay: Yeah. And full disclosure to our listeners, Shail and I are working on the National Taxpayers Union case, so you can always reach out to us if you do have questions, but we are anticipating that those will move fairly quickly, which I think is a good thing because there's a lot of uncertainty and I really know people are ... I've had a lot of conversations with folks on this [00:10:00] issue and this issue of the inconsistencies, I think that was kind of a sleeper issue, but it's really coming more to light as people are now starting to figure out, okay, even prospectively, how am I supposed to comply with this? One statute is saying everything's in and one statute is saying you can't include things that are deductible and what does that mean? So I think a lot more to come on this litigation.

And then also, this is just going to be an ongoing struggle for taxpayers [00:10:30] to try to figure this out and maybe we could get a legislative solution this session that would actually provide some clarity and apply what the legislature's will is in a constitutional way, but TBD. Any final thoughts on that one?

Shail Shah: Fingers crossed. No, I think 2025 is going to be a pivotal year for that particular statute, and we'll see more to come. I'm sure [00:11:00] we're going to have another podcast on this case.

Nikki Dobay: Another 70? No. All right, so let's flip over to the FTB and there's been a saga going on for many, many years. I mean, New York has been talked about as they've been working on their market-based sourcing rules and unitary filing rules for 15 plus years. How long has California been working on its market-based sourcing rules?

Shail Shah: [00:11:30] So it started back, and I'm pulling up my notes here, January of 2017, and that was when the first interested party meeting started in California. And California implemented on an elective basis market-based sourcing back in 2011 on a mandatory basis in 2013 for most taxpayers. So it's been around for a while.

Nikki Dobay: Okay. So there were no regs up until 2017.

Shail Shah: There were [00:12:00] skeletal regs and then there was a change in 20 ... I want to say 2014, there was an updated reg. And then 2017 is when they started the larger project. So this has gone through six interested party meetings and California agencies are not necessarily required to, but typically, especially if the reg project is large, they'll hold interested party meetings to solicit comments from the taxpayer community. And it has gone through, I would say countless [00:12:30] and countless different iterations. But we are now finally at a point where at least at the administrative level, at the FTB level, the interested party meetings are done and they're getting ready to submit this or submit the reg project to what they call the Office of Administrative Law, which is the agency that would actually promulgate and finalize the regulation.

- Nikki Dobay: So up until now, these regulations have never actually been finalized through the official APA process?
- Shail Shah: [00:13:00] That's correct. Okay. It's just entered into the APA process.
- Nikki Dobay: All right. From your perspective, what are the highlights here? Who are the winners? Who are the losers? Are there still controversies over the ... Do we anticipate that, I know there's a public hearing coming up at the end of the month. Are people still going to be commenting or have we beat these rules up so much that everybody's just walking into this office of administrative something or other and we're going to just say, "Let's [00:13:30] pass it?"
- Shail Shah: Yeah. I think Nikki, you and I know with any sort of apportionment project, there's always winners or losers and there's this sort of constant tug of war between different industries and if you're an in-state taxpayer versus an out a state taxpayer. So at the end of the day, people have been fighting over the substantive piece for seven years. There's substantive changes to asset management rules, US government contractors, source income, how [00:14:00] companies in early stages of research and development, when they receive milestone payments, how do they source their sales.
- So to me it seems the substantive portion has beat pretty heavily over the last seven years. I think a lot of the comments we're going to see around the implementation. One of the changes that we recently saw just on Monday was the effective date was supposed to be January 1st, 2024. There was a lot of pushback [00:14:30] and FTB agreed to change it to January 1st, 2025 to allow taxpayers to sort of at least think through how these changes are going to impact their business, how can they actually implement the changes? Do they have to make changes within their systems to account for some of these amendments? So I think we're going to see a lot of it around more of the procedural implementation aspect of the regs.
- Nikki Dobay: But as you said, these have been mandatory or market-based sourcing has been mandatory since [00:15:00] 2013. So I assume there's some taxpayers that have been following various iterations of these regulations because as you said, they have changed. Have those issues just been addressed on an ad hoc basis on audit? Have they been afforded some protections for following these drafts or are we just not there yet?
- Shail Shah: Well, it's been applied on the ad hoc basis, both by the FTB and by the taxpayers. [00:15:30] I think I applaud the FTB for their persistence and soliciting comments from taxpayers, obviously to have a well-rounded robust regulation before they submit it to the OAL. The downside of this really long process is that there has not been clear messaging from the FTB. And so as you mentioned, some taxpayers have been sort of applying it on [00:16:00] ad hoc basis because they view it as well, this is the FTB's interpretation of the statute. But then the FTB has also been applying on audit the regulations on ad hoc basis. At times

they say, "Look, it doesn't apply because they're not final." And other times they're saying, "Well, this is our interpretation of the statute and this is our intention of how the statute is supposed to be applied." And so you have a lot of sort of mismatch and inconsistencies between different taxpayers.

Nikki Dobay: So what you're saying is you think [00:16:30] there's going to be some challenging audit situations where taxpayers are going to have to either try to resolve it directly with the FTB or potentially push beyond the audit phase at the OTA or wherever and say, "This is what we think the statute says, and it doesn't matter what this draft in 2018, 2019, 2020 said."

Shail Shah: Yeah, I think that's exactly right. And it's always a challenge of regulations because you have an [00:17:00] effective date, but if the regulations explain the statute, you have the sort of push and pull as to, well, if it explains the statute, then why doesn't it apply retroactively? But then why do you have an effective date? And I think we're going to see challenges again at OTA and challenges against the FTB on which provision do you apply on a retroactive basis versus on a prospective basis?

Nikki Dobay: This is raising more questions than it's settling satellite for me right now. First, I mean we've got the Loper Bright angle [00:17:30] and that takes on a whole new life in California because of the AMCA case, which I think was that just last year? Was that 2022? My years are melding together. So this was the case that challenged the FTB's release or publication of a new guidance on 86-272 based on the MTC model. And that was challenged and thrown out as being procedurally [00:18:00] invalid. And the FTB ... I want you to tell us what the FTB's reaction to that was.

Shail Shah: Well, the FTB has, and I like using this analogy, took a bazooka to a fly and instead of just removing the 86-272 guidance, which the Superior Court said was invalid under the Administrative Procedures Act, they took away all of their guidance. 100% of it's taken off their website. So now if [00:18:30] you go onto the FTB's website, you go to legal, you try to look up any of the rulings, nothing is there anymore.

Nikki Dobay: And do you have any insights if they're going to ... Are they just not going to issue rulings anymore?

Shail Shah: They have not said anything about this issue. They have been very, very mum about how they're going to proceed. I will say the old chief counsel, Giselle Burnett recently retired. There is an acting chief counsel right now. [00:19:00] I think they're not saying anything because effectively they want to see what the new chief council is going to do, whether that's Shane Hofeling or if it's somebody else, what their view is on this issue.

Nikki Dobay: I think your analogy is quite good. The AMCA challenge was everybody wants to get to the substance of whether or not the MTC's new 86-272 guidance is

constitutional. And that challenge unfortunately did not get us there. And from my perspective, [00:19:30] it's created new challenges because while we don't want agencies out there just creating underground rules and being provided deference for those, we do want to know agency's thoughts on things so taxpayers can at least decide are they going to follow that and be conservative or are they going to say, "No, we actually disagree with that position, so we're going to take that issue on ourselves?" So seems like we're in a bit of an inflection [00:20:00] point with the FTB, and so your insights are we're going to have to wait for the new chief counsel to be named.

Shail Shah: Yeah, and I'll say one more thing on this issue. There is a sort of inequity standpoint with the FTB pulling all these notices down because look, taxpayers that can afford the services of Greenberg Traurig, for example, I have the luxury of having access to all of those notices. I have [00:20:30] those downloaded, I have a library-

Nikki Dobay: Shail has a secret stash of FB ruling. You're hearing it here.

Shail Shah: I have a secret stash of all those notices. But if you are a midsize to small taxpayer that unfortunately cannot hire a Greenberg Traurig or another, a large [inaudible 00:20:48] or a law firm, you won't have access to those guidances. So you actually don't know what the FTB is thinking and you're effectively at a disadvantage, which I think is generally unfair to the taxpayer community.

Nikki Dobay: [00:21:00] Well, I also see another scenario where we're seeing a lot, and this isn't California specific, but you're seeing a lot of folks retire, you're seeing a lot of new people come into the agencies and those rulings at least provided a lot of institutional knowledge that could be looked at. And so there's going to be a group that also has access to those at the FTB. I'm sure everybody could have access to them at the FTB, but newer folks may [00:21:30] in five years, maybe a rulings ... They're not ever going to have seen a ruling. So I just think this was one where the result was kind of a quick yay taxpayer wins and then like, oh dear, what just happened? All right, so we have no real answers in California is what I'm hearing. We just have to keep waiting and think what's going to happen.

Shail Shah: Exactly.

Nikki Dobay: Yeah. Okay. All right. Well Shail, thank you so much for catching us up. [00:22:00] I'm sure we will be back. California is always a very hot topic. Before I let you go, do have to ask a surprise non-tax question. And as I was thinking about what could be a great question to ask today, something really tragic happened in my life this morning. My espresso machine will not work. It keeps telling me it needs more water and it does not. And so my question to you is, what do you do in the morning when your coffee maker or teapot, whatever [00:22:30] it is you drink to get going, stops working? I'm still working through this process. I'll probably have to pull out my French press and figure out how to

use my old coffee grinder. I know the challenges in our lives, but what would you do if that really important morning appliance that wakes you up, stops working?

Shail Shah: Two words, or actually I think they put the words together: DoorDash.

Nikki Dobay: Okay, I live in [00:23:00] Bend, so I'm not sure that's an option, but do tell me more.

Shail Shah: I've had the broken coffee machine episode before and I have just instantly ordered coffee and it's come within 15 minutes and it's the best thing.

Nikki Dobay: Wow. I'm really happy I asked this question because I mean, I could get in my car and drive to the coffee shop, sure, but we had a podcast to do, so that would've been a much [00:23:30] better solution. So thank you for that and thank you for the update. And thank you for the listeners. We're really looking forward to 2025, lining up a lot of great guests to join us for the show so do be on the lookout. If you have any questions or comments, please leave them in the show notes, contact information for Shail and I will also be in the show notes and I will be back with you again in a few weeks on the next Gettin' SALTy.