BEFORE THE OFFICE OF TAX APPEALS

STATE OF CALIFORNIA

IN THE MATTER OF THE APPEAL OF,	
KIMCO REALTY CORPORATION and SUBSIDIARIES,	OTA NO. 230713916
APPELLANT.	

TRANSCRIPT OF PROCEEDINGS

Sacramento, California

Wednesday, October 22, 2025

Reported by:
ERNALYN M. ALONZO
HEARING REPORTER

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IN THE MATTER OF THE APPEAL OF, KIMCO REALTY CORPORATION and SUBSIDIARIES, APPELLANT.	OTA NO. 230713916

Transcript of Proceedings, taken at 400 R Street, Sacramento, California, 95811, commencing at 1:02 p.m. and concluding at 2:39 p.m. on Wednesday, October 22, 2025, reported by Ernalyn M. Alonzo, Hearing Reporter, in and for the State of California.

APPEARANCES:

Panel Lead:	ALJ TOMMY LEUNG
Panel Members:	ALJ JOSH LAMBERT ALJ GREG TURNER
For the Appellant:	KATHY FREEMAN TONY FULLER JAEMIN KO
For the Respondent:	STATE OF CALIFORNIA FRANCHISE TAX BOARD KEN HAVENS KATIE FRANK

I N D E X

E X H I B I T S

(Appellant's Exhibits 1-28 were received into evidence at page 6.)

(Department's Exhibits A-L were received into evidence at page 6.)

OPENING STATEMENT

CLOSING STATEMENT

Sacramento, California; Wednesday, October 22, 2025

1:02 p.m.

JUDGE LEUNG: I'm going on the record.

This is the Appeal of Kimco and Subsidiaries. The Docket Number is 230713916. Tax years in dispute are 2014, 2015. The issues are whether: No. 1, the proposed assessment of $203,748 for 2014; and No. 2, to propose assessment of $81,921 for 2015 was erroneous; and No. 2, there's a -- what Ms. Freeman referred to as an auxiliary issue of NOL carry overs.

Ms. Freeman, as I was reading through the briefing, I imagine what you're trying to say is whether the carryover computations for 2016 NOLs is correct because they were used based on the 2014, 2015 impositions?

MS. FREEMAN: Correct.

JUDGE LEUNG: And should you prevail, there would be some adjustments to the amount of NOL carry overs to 2016; is that correct?

MS. FREEMAN: Correct.

JUDGE LEUNG: Okay. Great.

FTB any questions about that auxiliary issue?

MR. HAVENS: No, Judge.

JUDGE LEUNG: Okay. Good. We have exhibits that

are going to be admitted into the record right now. Taxpayer's Exhibits 1 through 28 and Franchise Tax Board's Exhibits A through L were not objected to at the prehearing conference, and they are now being admitted into the record.

(Appellant's Exhibits 1-28 were received into evidence by the Administrative Law Judge.)

(Department's Exhibits A-L were received into evidence by the Administrative Law Judge.)

JUDGE LEUNG: Today is October 22nd, 2025. It's approximately 1:05 p.m. in Sacramento, California. The issues, as I mentioned before are -- or as I stated -- and I'm going to have the -- before we do that, introduce my co-panelists. To my right is Judge Lambert. To my left is Judge Turner. Even though I'm the lead for today's hearing, we on the panel are all co-equals making the decision in this case. We will endeavor to issue a written opinion within 100 days after the record is closed.

I will now have the parties introduce themselves.

Ms. Freeman.

MS. FREEMAN: My name is Kathy Freeman. I'm a CPA with Deloitte Tax representing Appellant.

JUDGE LEUNG: Welcome.

MR. FULLER: My name is Tony Fuller. I'm a CPA

and JD working for Deloitte.

JUDGE LEUNG: Welcome.

MR. KO: My name is Jaemin Ko. I'm also a CPA and working for Deloitte Tax LLP.

JUDGE LEUNG: Welcome.

Franchise Tax Board.

MR. HAVENS: Good afternoon. My name is Ken Havens with the Franchise Tax Board and my colleague.

JUDGE LEUNG: Welcome.

MS. FRANK: Hello. Katy Frank also with the Franchise Tax Board.

JUDGE LEUNG: Welcome. Thank you.

Today's hearing will take approximately 100 minutes. I've allocated 45 minutes for Kimco and Subs, and 35 minutes for the Franchise Tax Board.

Ms. Freeman, your 45 minutes can be used however you wish to use it. You want to reserve 5 minutes or 10 minutes for rebuttal, that is okay. But whenever you're ready, please start at your pleasure.

MS. FREEMAN: Thank you, Judge Leung.

PRESENTATION

MS. FREEMAN: We're here today to discuss the combined report filed by Appellant's real estate investment trust, which is short for REIT, who is the

parent in the key corp and its taxable REIT subsidiary, TRS for short, for the taxpayer members of this group return. While there are other taxpayers in the group, these are the only two taxpayers, really, at issue in this case.

At issue is whether, in the calculation of the combined taxable income in the combined report, taxpayers are entitled to eliminate intercompany dividend income paid by the TRS to the REIT. So, basically, it's parent sub-relationship, and a dividend was paid during the tax year. The issue of whether Appellants may eliminate intercompany dividends is present in both years. They're -- the Appellant's eligibility for the DPD deduction is not in dispute, which is a separate issue for -- in the subchapter regime and in the Respondents have acknowledged in multiple briefs that Respondents are entitled to the DPD deduction. There's no dispute that the DPD is the same number for California and federal purposes and is the actual amount paid by the REIT to its shareholders. There's no federal or state conformity issue or adjustment required to the DPD.

Appellant's NOL deduction is causally impacted by the determination of the eligibility for this dividend elimination, and there's no dispute that the TRS and the REIT are entitled to an NOL deduction. The question is

how much. At the end of this, in the event that Appellant prevails, we have requested fees in this case.

So to begin with, the basic rules under 2516 -- we're going to spend time addressing the Appellants -- or the Respondent's arguments. But really, 25106, in short, provides that dividend paid in -- from unitary EMP shall -- it's mandatory -- be eliminated in the computation of the combined report taxable income. TRS paid a dividend to REIT. This is not disputed. The income and the EMP from which the TRS made the distribution to the REIT was included in a combined report for all years that the TRS existed, and the TRS and the REIT have refiled a combined report for all years, making the EMP unitary EMP.

The dividend income of the TRS and the REIT -- actually, the TRS paid the dividend to the REIT. The dividend income of the REIT is listed on line 4 of the Schedule F. It's listed on line 4 of the 1120 reflecting that it is an income. And then any deductions are separately stated in the return, including the DPD. A deduction and expenses do not remove an item of income from gross income. It reduces taxable income to determine that income subject to tax. And it's also important to point out that the DPD is a completely separate issue from the issue of whether a dividend qualifies for elimination.

Respondents have made multiple allegations in this case, and the arguments have morphed over the course of the dispute. During -- during the dispute that the Appellant or Respondent has claimed that Appellant has made an impermissible double deduction; Appellant has claimed impermissible double tax benefit; that Appellant is not eligible to eliminate the dividend paid by the TRS to the REIT; that the Appellant cannot claim a dividend elimination because it is a REIT; Appellant is statutorily prohibited from eliminating the dividend income; that the dividend at issue is not in REIT's income and therefore, cannot be eliminated; that it is not the intent of 25106 to allow Appellant to eliminate the intercompany distribution; that there is no double taxation in this case, and that allowing the dividend elimination is contrary to the REIT taxation regime.

We reject these arguments. They're all without merit. The statue is absolutely clear in this case, and the legislative intent in this case is not of issue because the statue is clear. And I think even if the legislative intent is at issue, it's very clear that the legislative intent that we follow the federal regime and that the dividend is eligible for elimination. With respect to California conformity to federal law, we adopted Subchapter M back in the early 1990s when we

adopted 24870. There's some ancillary code sections thereafter that specifically address the different categories of entities in Subchapter M, including REICs and REITs.

REITs are permitted to own a TRS, which is a taxable REIT subsidiary. Taxable REIT subsidiaries can perform actions that are not allowed to be conducted by a REIT, but they can also conduct activities that a REIT is allowed. REITs can also own qualified REIT subsidiaries, which are disregarded entities, which are allowed to conduct activities of the REIT. A TRS conducting activities that are prohibited to be conducted by a REIT cannot be included in a consolidated return. However, a TRS conducting activities as a REIT is permitted to conduct, can be consolidated or not at the election of the REIT.

And then a REIT for federal purposes cannot file a consolidated return with another REIT. And usually, ownership isn't present anyway because the shareholders of the REIT -- there's multiple shareholders, and they -- they fail the 80 percent test. The same problem exists for California as well, that REITs are generally not combined because you don't have common ownership. Unlike federal though, California has required unitary REITs, TRSs, QRSs to file a combined report. This includes TRSs

that conduct allowed activities and TRSs that conduct prohibited activities.

So while a federal consolidated return can include a REIT that has allowed activities, California allows TRSs that have prohibited and allowed activities to be in a combined report. The modifications to California's conformity to the federal rules for REITs are in Section 24872. And the legislature considered the tax -- re-taxing regime and chose modifications to allow combined -- these combined -- combined activities and combined report. Also relevant here is that the federal regime contemplates disallowing the 24243 deduction, which is the equivalent to our 24402 deduction. And we similarly disallowed deductions for dividends paid to a REIT that qualify for deduction under 24402. This differs from dividends distributed under 246, which are dividends from consolidated group members.

The 246 deduction is similar to the elimination of dividends under 25106, but it's referred to as a deduction and is reflected on line 29 of the 1120 versus for California. It's an elimination deduction. And it's -- it's really not a deduction, just elimination from income for all purposes. When California adopted Subchapter M, the legislature would have sent over the legislation for review to the agency, the FTB, that's

impacted by the legislation. And the FTB legal and audit would have reviewed that legislation for language issues and conformity issues, and then would post on their website their legislative analysis of the bill. And it's publicly available to anybody that looks at the FTB website.

So and -- when you look at the conformity language, California conforms to the dividends paid deduction without modification. And even though the REIT's taxable income and EMP can differ for California purposes and federal, the DPD deduction remains unchanged because it's the actual amount paid. And that's what is used to determine the requirement, which is unique to REITs. They are required annually to distribute 90 percent of their taxable income based on federal TIs. So we don't apply a different standard. If you qualify as a REIT for federal purposes, you qualify for state purposes. And that's why there's no modification for those rules to make sure that you -- you have to be a REIT for California purposes if you're a REIT for federal purposes.

Section 24872(c)(2) addresses the issue of dividend income and deductions, and only disallowed the 24402 deduction, which is now unconstitutional, but it's similar to the federal disallowance of the 243 deduction. And, basically, it's just exchanging state stat -- state

provisions for federal provisions. There's no disallowance in the federal regime for dividends under 246, which is the dividends paid to members of a consolidated return, which would be similar to the dividend elimination under 25106.

So such a deduction, if a TRS and a REIT were in a consolidated return, would be permitted and would be reflected on line 29 of the return. In California -- for California purposes, because there's no mention thereof any REIT that had dividend from an insurance company that qualified, that had CFCs foreign dividends or dividends from a combine report member are permitted because they're not specifically disallowed. And there's no provision in 25106 specifically addressing REITs or TRSs.

In the day, back in 2003, because the conformity language was originally the same -- the same for real estate investment conduits, which are REICs, originally they had only disallowed the 24402 deduction, similar to what's for REITs. California found that abusive and changed the statute to disallow the deduction under 25106. And in -- did not make a similar change for the REIT provisions because they found it to not be abusive. That's in -- that's within the Respondent's brief.

And then let's get to the combined reporting rules. Combined reporting is required for a REIT and a

TRS where ownership is present. TRSs are a function of the REIT, and it would be very difficult for a TRS to found not to be unitary. California does have a rule for S corps that prevents combination. There's no similar rule present her for REITs and TRSs. They could have done so, but they did not.

So in the combined report, the income of the combined report members is included in combined in the income and the apportionment factors of the groups is combined, and income from the combined report is then apportioned out to the respective taxpayer members and to determine the respective liability. Both the REIT and TRS in this case paid tax. The combined report does not alter a REIT or a TRS' EMP calculation. If you look at Young's Market, while I may take positive income from one member and negative income from another and net it out to be an overall net loss, that does not change the respective EMP of the -- the legal entity based on Young's Market. And then that's also consistent if you look at FTB's former TAM 2005-0001, which is similarly finds that EMP would include any dividends, even if they're eliminated in the calculation of EMP.

And then let's now get to the issue of the original basis for the FTB's adjustment was that Appellant claimed a double deduction. We did claim elimination

under 25106. 25106 is an elimination, not a deduction. Therefore, it's not possible for us to have claimed a double deduction in this case because elimination is for all purposes. If you read 25106 which -- (a)(1), which is the relevant section in this -- A, paragraph 1, in any case in which the corporation is or has been determined under this chapter with reference to the income and apportionment factors, one or more other corporations with -- which it is done -- is just doing or has done unitary business, all dividends paid by one to the other of any of those corporations shall -- shall -- not permissive -- to the extent those dividends are paid out of income previously described as a unitary business be eliminated from the income of the recipient.

This statute, which is independent from paragraph 2, goes on to express or provide that except for purposes of applying 24345, which deals with deductible taxes, shall not be taken into account for purposes of -- of 24344, which is the --

JUDGE LAMBERT: Excuse me. Could you please slow down.

MS. FREEMAN: Oh, sorry.

JUDGE LAMBERT: Sorry. Thanks.

MS. FREEMAN: Okay. I'm just reading the statute in (a)(1).

JUDGE LAMBERT: It's for the hearing reporter, Ms. Alonzo. Thanks.

MS. FREEMAN: Okay. The statute, which is independent from paragraph 2 of section 25106, goes on to expressly provide that, except for purposes of applying section 24345, shall not be taken into account under section 24344 or in any other manner in determining the tax of any member of the unitary groups. This is a prohibition from taxing an inner company dividend paid between combined report group members. The purpose of 25106 is to allow movement of EMP amongst group members so that -- to facilitate distributions ultimately out to the ultimate shareholders.

Yet, it's important to point out this is exactly what the FTB has proposed to do in this case. Intercompany dividends are eliminated, not deducted. So Appellant could not have possibly claimed the double deduction. If you look at the case in Fujitsu, they -- they go on specifically say that's the absolute intent, and language could not be more clear that it's absolutely to prevent double taxation of income. Three income includes now the dividends and earnings paid from the TRS, which were previously taxed by inclusion of the TRS's income in the combined reports in all years.

Further, I'd point out that there is no language

in either 25106, 424872, or even 24870, for that matter, which is our conformity to subchapter (m), that prevents or precludes a REIT from eliminating this intercompany distribution. FTB argues there's no double taxation in this case. We disagree. The TRS is in the combined report. There's no dispute over this. It goes into the combined report calculation of income. It goes into the combined report calculation of apportionment. And the use of the numerators of the apportionment formula then divvy up the income subject to tax between the taxpayer members to ensure that their liability is paid.

As a function of the combined reporting, for example, the losses reported by the rest of the group members for an -- where an entity has positive taxable income would offset that income. And even though a particular entity has taxable income, the losses could offset that, causing it to have a loss that does not impact their EMP. But here in this case, the TRS has separate company EMP and earnings, which are being distributed up to the REIT. And because the REIT has included them in their taxable income, on line 4 of the their return, the income is again being taxed.

And absent elimination, that income would be taxed twice; once in the form of current earnings, and secondly, in the form of dividends when paid. In this

case, the first dividends were paid in the tax years in dispute, and this is the first occurrence of this problem. 25106 is a mandatory provision.

MR. FULLER: Before you go on, can I?

MS. FREEMAN: Okay.

MR. FULLER: I think this -- this -- the double taxation issue is a key issue here, and it's worth spending a little bit more time on. Maybe talking through the specific numbers just to make sure, you know, we're all -- we're all looking at this the same way. The -- the intercompany dividend elimination required by the statue section 25106, it does not create a double benefit. And, in fact, it does do as its stated intention to prevent double taxation. And just to -- to illustrate this, I -- I have here -- I have Respondent's opening brief from 12/1/23. And on page 3, they have a -- and just to take 20 -- 2014 as an example, they have an illustration of their position of why there's a double benefit being created.

And effectively what -- what they're -- what they're asserting is that first taxpayer takes a dividends paid deduction at the REIT level. And the secondly, they take an elimination which, per their words, removes the -- its K -- the KRS, the taxable REIT subsidiary takes a dividend of -- the elimination of $67 million, removing it

from income for a second time. And I think that's their key point is that there's a second elimination happening here.

What's a -- what -- they're missing a key fact, a key step in this process that I think helps -- helps understand our point in that the -- the federal consolidated return does not include the TRS. The -- the QRS -- the QRS is not in the federal return because, under these facts, it's not allowed to be. In California the QRS is required to be included in the combined report. So Step 1 is to add QRS's taxable income back into the group for California combined reporting. You have the tax returns. There are -- there are these columnar statements in the back of the tax return that you can't read, and I barely can either.

But the -- the -- in here you have the -- the REIT on one side, and you have KRS, the taxable REIT subsidiary, on the end. And what it's doing is it's adding to the federal income amount, $44 million for federal purposes of KRS's income going into the California combined report. So, effectively, what that nets to is 40 -- $44 million of net income of all the entities that starts on the -- the 2014 California --

JUDGE LAMBERT: Sorry to interrupt. Sorry. Could you please move the microphone closer to you because

they can't hear you on the stream.

MR. FULLER: I apologize, Your Honor.

JUDGE LAMBERT: Maybe a little closer.

MR. FULLER: Is this -- do you want me to -- is that better? Can you hear me now?

JUDGE LAMBERT: Yes.

MR. FULLER: Okay. Thank you.

I think the key -- so the key is the -- the federal income that is then flowing into the California tax return of -- is now $44 million, includes $44 million -- 40 -- hang on. Or in -- actually, after modifications, it includes $49 million of California taxable income. And then there's a -- and the distribution of $67 million, which is both -- includes the $49 million of current year California income, plus $18 million of prior year California income, which was on the prior year California combined report.

So those two the -- the distribution is included in the tax base, plus the income of QRS is included in the tax base of California. So without elimination, that item of -- those items of income are taxed twice. That is why the statute section 25106 requires the elimination of a distribution of a dividend between members of a unitary group.

MS. FREEMAN: So yeah. It's -- it's double

counting the income, once in the form of current year and prior year taxable income, and in the current year as a distribution. And the whole point is not to tax it twice. And by denying an elimination that's clearly permitted under the statute under 25106, you're causing double taxation, not preventing it.

Another provision we need to talk about is FTB has raised section 2 -- section paragraph 2 of section 25106(a). Section -- paragraph 2 of section (a) was a new provision added in 2009, and it does have both a provision for new members of the group that were not necessarily in existence when the unitary EMP was generated. But because they were unitary from inception permitting a deduction, this addressed a technical flaw in the original legislation and is acknowledged in footnotes. So it's intended to apply retroactively to cure that technical flaw.

And also, within paragraph 2, there's another provision section (b) that is an anti-abuse provision that allows FTB to deny that elimination transaction when it's entered for tax avoidance purposes. Section (b) applies only to provisions of paragraph 2. It does not apply to section paragraph (a)(1), which is the provision we're using to claim the deduction. This is not a new member of the group. It wasn't recently formed. And the anti-abuse

provisions don't apply. Further, I think when they cited the changes to the REIC provision, the FTB and the legislature acknowledge there's no abuse in this transaction. So the provision would not apply anyway.

And then with respect to section 25106(b), these rules apply to allowing the FTB to draft regulations to prevent disallowance of dividend elimination in that -- where it may occur to prevent it from not being deducted. In this case, the only thing that's preventing us from deducting an elimination -- I'm sorry -- eliminating the distribution in this case is the FTB. And the section in 25106(b) doesn't help their case. It just allows for them to draft regulations to prevent it from not being -- from being denied.

Respondent has alleged that Appellant is not eligible to eliminate the dividend paid by the TRS to the REIT. Contrary to this assertion, which we disagree with, the FTB section 25106(a) and 24872 both permit the elimination of the dividend in question. So we have not determined why the Respondent believes we're not eligible to eliminate the dividend when the statute is clear that where a dividend is paid from unitary EMP, it shall be eliminated. And there's nothing in 24872(c) to prevent that.

And I would actually add further that when they

modified the REIC rules to permit -- or disallow the -- the 25106 elimination, they deliberately chose, in the legislative intent, not to make similar changes to the REIT. I think it's important to note that the FTB, the Respondent, has cited Fujitsu and provides that with respect to 25106, legislature hardly could have chosen words with a clear meaning. Simply put, section 25106 ensures that the amount included in the combined income of a unitary group can be moved in the form of dividends among members of the unitary group without tax consequence. That is exactly what has happened here.

The reason for this is also clear. In a combined unitary group, the subsidiary's apportioned earnings are taxed as income in the unitary business. Because the State has already taxed the earnings, which is clearly what has happened here already, adding dividends that were paid, the dividends themselves are not subject to taxation.

JUDGE LAMBERT: Excuse me. Sorry to interrupt. But I think you should read a little slower just --

MS. FREEMAN: Okay.

JUDGE LAMBERT -- so we can properly get our official transcript transcribed. Thanks.

MS. FREEMAN: Okay. Let me restate this.

The legislature could have hardly chosen more

clear words. Simply put, section 25106 ensures that the amounts included in the combined income of a unitary group can be moved in the form of dividends, distributions of EMP, among members of the unitary group without tax consequence. That's what the elimination under 25106 accomplishes. The reason for this is also clear. In the combined unitary group, in this case, the TRSs in earnings are already in the calculation of unitary business income. Because the State has already taxed the earnings, whether currently or in prior years, the earnings, when paid out as dividends, should not be subject to taxation. FTB has proposed the exact opposite in this case, and has proposed the taxes and dividends again when paid. I would also point out that the dividends created no new income to the group when distributed as it's all paid out of unitary EMP and merely shifts EMP from one member to the other.

Respondent has also argued that these are used -- unique circumstances. They are not. This will occur in any circumstance where a REIT and a TRS are in a combined report. Further, at the federal level, this would not be a unique situation if a REIT elected to file a combined report with a TRS not conducting prohibited activities. What you would have is in a consolidated return, which has a joint several liability treating the group -- the consolidated group members as a single legal entity, would

in fact, allow a 246 deduction on line 29 of the 1120 return for any distributions from the TRS to the REIT, if they had elected to file a consolidated return. You would end up with the exact same result in a federal return as we have resulted here in this case.

I would also point out that when you do the DPD calculation, the DPD, although you're filing a consolidated return, the DPD deduction is exclusively based on federal taxable income of the REIT. So you take income of the REIT, which would include the TRS's dividend, you would take its allowed deductions, and because the REIT is allowed -- or required to distribute 90 percent or more of its income annually to qualify as REIT, they would then calculate the DPD based on line 28 of the 1120. So 90 percent of that number is then deducted once it's determined on line 27 as a DPD deduction.

The federal taxable income will not include the 246 deduction because it's on line 2029. So you end up with the same exact result in a federal consolidated return had they filed a consolidated return as you would in the California return filed by the Appellant in this case. So they're saying it's unique. It's not. You end up with the exact same results if -- if you had done this in a federal consolidated return.

They have also argued that it's not the intent of 25106 to allow Appellant to eliminate the dividend. We absolutely disagree with this contention. FTB reviewed, as well as the legislature, its conformity to the subchapter (m) and made some modifications. But, essentially, the rules are identical. This is a tax preferred structure. It's a federally preferred tax structure that has allowed preferential treatment and requires the passing through the taxation of the earnings of the REIT to its shareholders. The taxation is not intended to be at the REIT level. FTB has acknowledged that this is what is intended. That is accomplished through the DPD deduction, which requires them annually distribute at least 90 percent or more of its income.

Now, California's is not always 90 percent because we have state modifications. But we don't use a California number to determine whether a REIT qualifies as REIT. You use the federal numbers. This includes the DPD deduction, which is based on federal taxable income. So what -- what a DPD is, whatever the federal was paid out to the shareholders is the dividend paid deduction. It's a separate calculation. So a combined report income includes the dividends. They're eliminated if they are intercompany, and that is then apportioned out. And included in that number, which the FTB has acknowledged,

is a permitted DPD deduction, which is separate -- is a separate issue from this -- from this issue at which we're currently addressing, which is the elimination of dividends under 25106.

MR. FULLER: Can we confirm that California is the same?

MS. FREEMAN: Yes. The California conformity subchapter (m) does not change the DPD deduction. It's identical. It is whatever you actually paid to the shareholders. And we -- the reason you do that is you don't want to have them pay a federal DPD and then say, oh, the number is different, so you have to do something else for California, and then have to do it for 50 other states.

Again, they -- they had issues with the REICs back in 2003. They found that they felt that it was abusive. They went in and changed the conformity to subchapter (m) to add in a disallowance of the 25106 elimination in addition to the 2442 deduction. Because the language is identical in 24872, the legislative, at that time, could readily have gone in and made the same change to the REIT structure, and did not, leaving the language unchanged. But the legislative history, as Respondent aptly notes, did not express concern that a REIT structure could be abused similar to the REICs

transaction and continue to allow elimination. So this was a deliberate choice.

Again, the treatment would be the same if a TRS and a federal REIT was in a consolidated return. You would end up with no different result than you see here in the California return, which is consistent with conformity than you see in the subchapter (m) rules at the federal level. Again, there's no language or regulation that prevents the elimination of the dividend. It's clearly paid out of unitary EMP and is consistent with 25106 to allow it to be eliminated.

The FTB has also asserted that the dividend paid by TRS is not in REIT income. There's no -- there's no support for this assertion. So while you do eliminate intercompany income and dividends, this income is never actually posted to any entity's account. These are just computational adjustments. They're never posted to their books and records. And, basically, it goes into the combined report calculation. It is an income, which is why the elimination is required. You can see the dividends actually reported on line 4 of the return.

Let's see. What else? Further, if you look at the FTB's TAM 2005-0001, the conclusion 4 provides we will not eliminate amounts in R&C section 959(b) or section 25106 from the denominator of E -- which is EMP

and the CFC's inclusion ratio because it is income.

JUDGE LEUNG: Ms. Freeman, you need to slow it done a bit.

MS. FREEMAN: Sorry. Sorry.

JUDGE LEUNG: Okay.

MS. FREEMAN: So if you look at FTB's TAM -- which you can't find on the website anymore -- 2005-0001 conclusion 4 provides we will not eliminate amounts described in section -- I'll -- I'll shorten it up -- in section 25106 from the denominator, which is EMP, which is the CFC inclusion ration for water's-edge filers because they agree, consistent with Young's Market, that the dividend was actually received by the recipient, and it is EMP to the dividend recipient. Here, it is income. The elimination has no impact whatsoever on the calculation of REIT income, and it is an income, and it does need to be eliminated to avoid double taxation.

Appellant -- or sorry -- Respondent has also stated that Appellant is statutorily prohibited from eliminated dividend income. We disagree. R&T section -- R&TC section 25106 clearly allows the deduction at hand. REITs have not been perceived to be abusive in this case. FTB has, some degree, asserted that -- that the provision is abusive, claiming both a double deduction, a double benefit, et cetera. And there's no -- there's support for

these contentions.

And finally I think it's important to note the FTB has acknowledged the REIT structure is as attended, if the REIT shareholders are paying the tax, not the REIT, which is exactly handling -- happening in this case. And I think -- I think that was it for now.

So the conclusion that we have here is that FTB has denied what is clearly allowed as a deduction under 25106. There's no merit to any of their arguments for why 25106 should apply -- should not apply. Legislative intent is clear. It has been addressed on multiple occasions, both in 25106, in TAM 2005-0001 in Young's Market, and as well in the adoption of subchapter (m), which specifically allows this deduction -- elimination of income. And when they went through and modified the REIC rules, which have the exact same language, actually contemplated the similar rules in 25 -- 24872, and indicated they're not abusive and will continue to allow the deduction where it was denied for REICs.

And we'd like to reserve any residual time for rebuttal.

JUDGE LEUNG: Thank you, Ms. Freeman, Mr. Fuller. It's about 1:42, so you have about 18 minutes of rebuttal. No, about 8 minutes of rebuttal for later.

I'm going to turn to my co-panelists for any

questions for Kimco.

Judge Lambert, any questions for the taxpayer?

JUDGE LAMBERT: Yeah. I had a question. I was wondering, you were stating that you deducted -- made the deduction and then eliminated the income. But why did you do that instead of eliminating it first and then deducting from gross income going the other way?

MS. FREEMAN: So -- so the dividend paid by the TRS to the REIT is eliminated. So there was a dividend paid, and it qualifies to be eliminated because it was paid out of unitary EMP in the calculation of combined report taxable income. Separately, the REIT is permitted to claim a deduction for the distribution to its shareholders, which is a completely separate calculation based on the federal REITs federal taxable income, which would include the dividend paid by the TRS because the dividend is in federal taxable income, and the deduction for federal purposes, if it was in a consolidated return, would be on line 29. And the DPD deduction is based on 90 percent of line 28, which is before line 29.

JUDGE LAMBERT: Okay. I guess I just -- yeah. I was wondering because it seems like deductions are from gross income, and if something has been eliminated from gross income, then it wouldn't -- then the elimination would have already happened; and whether or not you can do

a deduction if the dividends -- if that income is no longer in the gross income if you could still do a deduction.

MS. FREEMAN: The dividend is an income, which is why it's eliminated. It's also TRS's income is in income. That's why it's double taxed, right. That's your combined report calculation. The -- the federal legislature, as well as California legislature, has separately allowed REITs as a tax preferred structure. If they make a distribution to its shareholders, allow an entirely separate calculation from taxable income of the REIT; a DPD deduction of the amount actually paid to the shareholders. It has to be at least 90 percent. It could be 100 percent. It could be 110 percent.

But that's a separate calculation from the issue of whether I have income moving within the return from the subsidiary to the parent, which is paid out of unitary EMP. It's a separate issue. They're not -- they're not correlated. And it would -- you would still have the exact same issue on a federal return if a TRS was in a consolidated return, which can occur if the TRS is conducting allowed activities, not prohibited. A prohibited TRS cannot be combined -- or consolidated for federal purposes. But a TRS conducting allowed activities can file a consolidated return with federal -- for federal

purposes.

That dividend would still be on line 4 for the federal consolidated return. It would be in taxable income that the TRS and the REIT that you see on line 28. And that line 28 number for the REIT only, which includes the dividend of the TRS, would include the TRS dividend, which would be times 90. It's intended calculation for federal purposes as well that -- and that the D -- the actual DRD would be on line 26, which is a separate calculation. So for federal purposes, the dividend from the TRS to the REIT would be subject to the 90 percent calculation for federal purposes as well. This is again, a federally sanctioned tax preferred structure that allows this calculation for both federal and state purposes.

JUDGE LAMBERT: Okay. Thank you. That's --

MR. FULLER: Maybe one point to address?

JUDGE LAMBERT: Okay.

MR. FULLER: Maybe this helps. Maybe it doesn't. But the -- the dividends paid deduction includes the TRS distribution of income, but it only includes the TRS's income once. But the TRS's income isn't added again to the California return. That's why the elimination needs to happen so that the TRS's income isn't taxed twice. The fact that there's a separate DPD allowed is -- is independent of the intercompany elimination issue. And

the DPD isn't being challenged by FTB. There -- that -- the calculation of the DPD isn't at issue.

But what seems to be at issue is the -- the elimination under 25106. But if we didn't have the elimination under 25106, the TRS's income would be subject to tax twice, which would always happen in a combined report if there's a dividend distribution between one member to another. And that's the -- that's why that -- that's such a germane and important provision of combined reporting. And FTB is asking you, I think to turn off 25106, which is a significant ask here.

MS. FREEMAN: Yeah. And I would -- I think you have to understand that it's permitted for federal purposes, but the mechanism of achieving that role is different for federal and state purposes. So for federal purposes, intercompany dividend is a deduction on line 29. This is a known federal, state difference. For California where you're in a combined report under 25106, dividends are eliminated in the calculation of taxable income. That -- that's a known federal, state difference. That was addressed when conformity occurred, and that was the way it was adopted.

And if they had wanted a different result, then they should have either made an exception in 25106 for REIT dividends. They should have required a modification

for the DPD. But 25106 as written and 24872 as written, permit the elimination of this dividend in the calculation, which is consistent with the tax preferred status of the REIT structure, which is intended to provide this tax benefit. If they wanted something different, they should have changed the statute. And they had the opportunity in 2003 to do so, and they did not. They actually said this is not what we consider abusive transaction. They looked at it.

JUDGE LAMBERT: Okay. Thank you. That's the only questions I have.

JUDGE LEUNG: Okay. Thank you, Judge Lambert.

Judge Turner, any questions from you?

JUDGE TURNER: Not yet. I'm going to wait on the Franchise Tax Board.

JUDGE LEUNG: Thank you.

Ditto for me.

So, Franchise Tax Board, you have 35 minutes. Please begin, Mr. Havens.

MR. HAVENS: Thank you, Judge.

PRESENTATION

MR. HAVENS: Good afternoon. As previously stated, I'm Ken Havens representing the Franchise Tax Board.

The question before the panel this afternoon is a simple one, whether a real estate investment trust or REIT, which deducted all of its income using the dividend paid deduction, is also entitled to eliminate income under California Revenue & Taxation Code or R&TC section 25106. For convenience, I'll refer to R&TC section 25106, which provides for the elimination of dividends from income under certain circumstances, as the 25106 elimination.

Appellant argues it is entitled to both the dividend paid deduction and the 25106 elimination. Both the dividend paid deduction and the 25106 elimination operate to shield income from taxation. However, Appellant want to apply both rules to remove the same item of income twice. In the presentation that follows, I'll explain why the law doesn't allow this. First, I'll discuss the relevant statutes in Appellant's facts before discussing why Appellant's position is contrary to law.

The Internal Revenue Code, or IRC, governs the operation of REITs in sections 856 to 860. The IRC provides that REITs don't compute federal taxable income under normal corporate rules. Instead, a REIT is taxed on a modified version of federal taxable income called REIT taxable income. Under federal tax law, REITs are allowed to deduct the dividends the REIT pays to its shareholders to arrive at REIT taxable income. This mechanism is

referred to as the dividends paid deduction.

This dividend paid deduction reduces a REIT's income. To qualify as a REIT. A REIT must pass 90 percent of its income, prior to the application of the dividends paid deduction, to the REIT's shareholders in the form of dividends. Because of the dividend paid deduction, REITs do not pay tax on the income that are passed to the shareholder. Instead, the REIT's shareholders are taxed on the dividend distribution, resulting in the taxation at the REIT shareholder level. This allows the REIT to completely remove income the REIT pays to its shareholders as dividends.

Again, I want to highlight that the deduction of income paid via dividends is a removal from income. This unique arrangement -- or this is a unique arrangement, as corporations are generally not allowed to deduct dividends paid to the corporation shareholders from the corporation's income. REITs also have special considerations regarding the dividends that the REIT and the REIT shareholders receive. Generally, federal law permits corporations to deduct dividends that they receive. However, under federal tax rules, a REIT is not entitled to a dividend received deduction, nor is a REIT's corporate shareholders entitled to deduct dividends received from the REIT.

This differs from the rule normally applicable to corporations where corporations deduct the dividends that they receive from taxable income under the dividend received deduction. As a result, under federal law, a REIT cannot deduct the dividends it pays -- or sorry. A REIT can deduct the dividends it pays to its shareholders, but cannot deduct the dividends it receives. The primary effect of these provisions and the primary benefit of REIT status is the avoidance of tax at the REIT entity level, and the payment of that deferred tax at the REIT shareholder level. An additional limitation on REITs, is that they're generally not permitted more than 10 percent of another corporation, ownership that is.

One notable exception is the taxable REIT subsidiary. As its name suggests, a taxable REIT subsidiary is not eligible for REIT treatment or the dividend paid deduction. Instead, the taxable REIT subsidiary is required to pay tax following traditional federal taxation rules. This means that the taxable REIT subsidiary cannot claim a deduction for the dividends it pays to its shareholders, including dividends paid to the REIT parent, and must pay taxes on its income.

California conforms to the IRC's rules regarding REITs and taxable REIT subsidiaries with limited modifications. An entity that is a REIT for federal

purposes is automatically a REIT for California purposes. California also requires that a REIT's California net income shall be equal to its federal REIT taxable income. California goes on to provide limited California modifications to that federal definition. Only the modifications specifically listed at R&TC section 24872 subdivision (c) are permitted for California purposes.

Notably, the 25106 elimination at issue in today's appeal is not a permitted modification to REIT taxable income under R&TC section 24872. Unlike federal authorities which generally preclude REITs and taxable REIT subsidiaries from filing the consolidated report, California requires combined reporting for corporations engaged in a unitary business, including REITs and taxable REIT subsidiaries. California's combined report aggregates the separate net income of all the corporations of the unitary group, and then apportions the relative share of aggregate business income to the combined reporting group members. However, despite requiring combined reporting, the separate net income of a REIT is still determined by the provisions of R&TC section 24872, which provides that a REIT's net income shall be equal to its federally defined REIT taxable income.

One final element of California law pertinent to today's discussion, is the 25106 elimination. The 25106

elimination provides that dividends paid from one member of the unitary group to another unitary member out of earnings of the unitary group that have already been subject to tax may be eliminated if certain requirements are met. This elimination constitutes a removal from income. The purpose of this rule was explained in Fujitsu ITT Holdings, Incorporated versus Franchise Tax Board, which provided that the dividend elimination is there to prevent earnings of a unitary business that have already been taxed, from being taxed a second time when distributed to -- as dividends within the unitary group.

Again, I want to highlight that the 25106 elimination, like the dividend paid deduction, constitutes a removal from income at the entity level. The legislature, in R&TC section 25106, provides that the Franchise Tax Board may deny the dividend elimination in certain circumstances. The statue provides, and I quote, "The Franchise Tax Board may deny any dividend elimination for dividends described in this paragraph, if the Board determines that a transaction is entered into or structured with a principle purpose of evading the tax imposed by this part," end quote.

Now that I've covered the relevant REIT provisions, I'll briefly discuss Appellant's facts and why Appellant's original filing position constitutes a double

tax benefit that violates existing law. While REIT mechanics and combined reporting mechanics are among the more complicated provision to their respective tax code, the facts underlined in this case are relatively simply. A REIT and a taxable REIT subsidiary engaged in a unitary business, and the REIT received dividends from the taxable REIT subsidiary.

In our diagram, which is currently on display -- it's also included as Exhibit M. This is Step 1. The REIT, after receiving these dividends, pass the dividends along to its shareholders and deducted all REIT income, including the income from the dividends the REIT received from its taxable REIT subsidiary using the dividend paid deduction. This results in a removal of the dividend paid from REIT taxable income.

This is Step 2 of our exhibit. As a final result of the application of the dividend paid deduction, the REIT removed all income and was in losses. I believe that visual is up on the screen now.

This is Step 3 of the exhibit. Finally, the REIT claimed that it was entitled to apply the 25106 elimination to eliminate the dividend income that had already been removed from REIT taxable income using the dividend paid deduction.

This is Step 4. So let's get a little bit more

specific with our facts. In Appellant's case, Kimco elected to be treated as a REIT. Kimco Realty Services, or KRS, was Kimco's taxable REIT subsidiary. Kimco and KRS were engaged in a unitary business, and Kimco filed a return which included both entities as combined reporting group members. KRS, the taxable REIT subsidiary, earned income in the years at issue, and paid Kimco, the REIT, millions of dollars in dividends for the years at issue. Upon receipt, Kimco included the KRS dividends in its computation of income under the REIT rules. Again, this is Step 1 of the diagram.

Kimco then passed the dividends it received from KRS along to its shareholders in the form of REIT dividends and claimed the dividend paid deduction. This is Step 2. The result was the removal of the dividend paid by KRS to Kimco, in Step 1, from Kimco's REIT taxable income. Application of the dividend paid deduction resulted in Kimco fully removing all items of income from Kimco's REIT taxable income, including the dividends Kimco received from KRS, resulting in Kimco having a negative REIT taxable income in the years at issue. Kimco claimed, after it removed all items of income, that it was entitled to an entity level 25106 elimination. This is Step 4.

Kimco's theory would remove the same item of income twice. In Appellant's combined report schedule,

they show this double treatment as a California adjustment. But to be clear, this is a second entity specific removal of the dividend income Kimco received from KRS. As we saw in steps 2 and 3, this income had already been removed. Appellant's claim that it is entitled to a dividend paid deduction, and a 25106 elimination is not supported by law. The 25106 elimination is not permitted under the plain language of R&TC section 24872.

Moreover, Kimco clearly deducted the KRS dividends from Kimco's income using the dividend paid deduction, then sought to eliminate the same income that had already been removed. Application of the 25106 elimination to remove the same item of income twice creates a double tax benefit. Not only are the double tax benefits not permitted by law, but allowing such a double benefit in this case yields an absurd result. I'll discuss each of these propositions in turn.

First, the plain language of R&TC section 24872 prohibits Appellant from applying the 25106 elimination. R&TC section 24872 subdivisions (b)(2) and (c), establish that a REIT's California net income shall be equal to the federal REIT taxable income, and that the only California modifications to REIT taxable income permitted under California law are enumerated at R&TC section 24872

subdivision (c). The permitted state modifications do not include the 25106 elimination. For this reason, the 25106 elimination is not allowed in the case.

The Franchise Tax Board already applied this logic to this case benefiting the Appellant at protest. Appellant adjusted its REIT taxable income on its original California return, making several adjustments that were not listed under R&TC section 24872 subdivision (c). Appellant made California specific adjustments to bonus depreciation deduction and deductions for taxes measured by income, increasing Kimco's separate net income. The Franchise Tax Board reversed those adjustments because they were not specifically listed under the statute. The protest officer's adjustments reduced Kimco's separate net income and the corresponding total group business income by approximately $18 million in 2014 and $52 million in 2015, benefiting the Appellant.

California statute only authorizes specific deviations from federally defined REIT taxable income. The Franchise Tax Board's disallowance of provisions, that are not explicitly contained within the plain language of the statute, satisfies the requirement that a REIT's California net income shall be equal to its REIT taxable income, unless modified. And it's consistent with California's conformity to federal law regarding REITs.

R&TC section 24872 also precludes the operation of the 25106 elimination from a logical perspective. As previously noted, a REIT's net income shall be equal to federally defined REIT taxable income, as the plain language of R&TC section 24872 provides that a net income of a REIT is equal to federal REIT taxable income. And REIT's taxable income is computed by taking a dividend paid deduction. Any income removed by the dividend paid deduction is already removed from the California income tax base and thus, is not available for elimination.

In addition to the plain language of R&TC section 24872, Appellant is also precluded from claiming a double tax benefit under California statutes and precedence. Both the dividend paid deduction and the 25106 elimination, remove the same item of income, the dividends Kimco received from KRS, from Kimco's income twice. Application of both provisions results in an impermissible double tax benefit. Moreover, as Kimco's REIT taxable income was already negative in each of the years at issue, the second reduction to Kimco's separate net loss offsets the income of other unitary members, specifically, Kimco's taxable REIT subsidiary, KRS. This result is contrary to applicable case law, statue, and sound tax policy.

The United States Supreme Court and California case law alike reject double tax benefits. Federal

precedence stem from the 1934 U.S. Supreme Court case, Charles Ilfeld Company versus Hernandez, which created the Ilfeld rule. The Ilfeld rule provides that taxpayers are prohibited from receiving double tax benefits from the same transaction, unless a double benefit is specifically authorized by law. In summarizing the Ilfeld rule in the 1969 case of United States versus Skelly Oil Company, the U.S. Supreme Court explained, quote, "The Code should not be interpreted to allow Respondent the practical equivalent of a double deduction," end quote; and further provides that any device allowing the practical equivalent of a double deduction requires a clear declaration of intent by Congress.

JUDGE LEUNG: Mr. Havens.

MR. HAVEN: Yes.

JUDGE LEUNG: Ilfo [sic] is spelled I-l-f-o?

MR. HAVENS: I-l-f-e-l-d, Judge.

JUDGE LEUNG: Thank you.

MR. HAVENS: The Supreme Court of California has likewise refrained from interpreting the R&TC to provide double tax benefits. In Great Western Financial Corporation versus Franchise Tax Board, the taxpayer received dividends from its subsidiary corporations, which it deducted under R&TC section 24402. In addition to removing the dividends from income, the taxpayer sought to

deduct expenses attributed to receiving those dividends from its income. Taxpayer sought to remove offsetting deductions, even though the dividends had already been removed from the taxpayer's income.

The California Supreme Court found that the Franchise Tax Board properly applied California statute -- in that case, R&TC section 24425 -- to prohibit a deduction attributable to income not in the measure of tax. This prevented the taxpayer from deriving a double tax benefit; once from deducting the dividends themselves and again, for deducting expenses relating to dividends that had been omitted from the tax base. The State Board of Equalization, or BOE, has echoed this prohibition on double tax benefits.

In Appeal of Missions Equities Corporation, the BOE rejected the taxpayer's attempts to take a double exclusion. In Mission Equities, the taxpayers received dividends from its subsidiaries and was allocated a corresponding dividend received -- or excuse me -- and took a corresponding dividend received deduction. Taxpayer also had expenses that the FTB deemed related to that income.

The BOE explained, and I quote, "The fact that the dividends received by Appellant were included in the subsidiaries measure of tax is the reason why they are

excludable from Appellant's income. However, this is no reason to allow a double exclusion by allowing a deduction of that portion of expenses which relate to the production of exempt dividend income. On the contrary, it's a compelling reason to make an allocation of expenses and to disallow those expenses which relate to tax" -- "relate to the tax income, which is what the Respondent has done," end quote.

This case law shows that the applicable -- that the application of both the dividend paid deduction and the 25106 elimination mechanism to produce a double tax benefit is impermissible. Under the Ilfeld rule, there is no indication that the California legislature intended a double tax benefit with the 25106 elimination. Moreover, the plain language of the statute indicates the opposite intent with the legislature providing that the elimination be denied if structured with the purpose of avoiding tax. Absent legislative intent to allow a double tax benefit, the R&TC should not be interpreted to provide one.

Finally, Appellant's position is contrary to both the intent of the re-taxation regime and the 25106 elimination regime and produces an absurd result. The Fujitsu court explained, and I quote, "A court must select the construction that comports most closely with the apparent -- intent of the legislature with the view to

promoting, rather than defeating, the general purpose of the statute, and avoid an interpretation that would lead to absurd consequences," end quote. The OTA should select construction of the REIT provisions and 25106 elimination that most closely conforms to the legislature's intent. Promoting the various statutes general purposes and avoiding interpretation with absurd consequences.

Regarding the REIT regime, Congress chose the dividend paid deduction as a way to ensure that a REIT's distributed income is taxed at the REIT shareholder level, rather than at the REIT level. California conforms to this theory of taxation. Kimco claimed the dividend paid deduction removing all the income paid as dividends to Kimco's shareholders resulting in no separate net income for the years at issue. After deducting all of its income using the dividend paid deduction, Kimco also sought to apply the 25106 elimination to remove an item of income that had already been removed, effectively doubling losses at the entity level. This creation and a creation of double benefits at the REIT entity level contravenes the structure and purpose of the REIT taxation regime.

Taxpayer's approach similarly frustrates the purpose of the 25106 elimination and the plain language of R&TC section 25106. The 25106 elimination ensures that previously taxed earnings of a unitary group do not get

taxed a second time as unitary intercompany dividends. California appellate courts have determined that the legislature's purpose in eliminating the dividends received by a member of the unitary group from another member of that unitary group out of unitary earnings was to ensure that unitary earnings are only taxed once.

However, in this unique scenario, that goal of removing dividends from income that have already -- has already been achieved under the REIT regime using the dividend paid deduction. Allowing the 25106 elimination to reduce REIT taxable income, which has already removed the dividends using the dividend paid deduction, would result in a transactional structure that artificially avoids the tax imposed under part 11 of the R&TC. This clearly contravenes the legislature's intent in drafting the 25106 elimination that group-wide earnings be taxed only once, and that transactions not be structured with the principle purpose of evading tax. Thus, in this case, applying only the dividend paid deduction is most in line with the California legislature's intent in conforming with the REIT regime and enacting the 25106 elimination.

Finally, Appellant seeks and interpretation of California law that would lead to absurd consequences. If Kimco is permitted to remove the KRS dividend from its income a second time using the 25106 elimination, then

Kimco artificially increases its separate net loss. This double tax benefit offsets other unitary members' income at the group level. This results in Kimco's double tax benefit offsetting the separate net income of KRS, the taxable REIT subsidiary whose supposedly taxable earnings generated the dividends to begin with. This results in the unitary group never paying the full tax on the earnings of the taxable REIT subsidiary. This undermines the purpose of the 25106 elimination, which is the tax unitary earnings of the Appellant's taxable entities only once, and the REIT regime's mandate to subject the taxable REIT subsidiary to the normal tax treatment. This constitutes an absurd result, which should be avoided.

To summarize, California law does not modify REIT's taxable income to provide a 25106 elimination to REITs. Moreover, application of both the 25106 elimination and the dividend paid deduction creates a double tax benefit that is not permissible under the plain language of the relevant California statutes or applicable precedence. Finding otherwise would create double tax benefit that belies both the REIT and 25106 elimination regimes, resulting in a windfall to the taxpayer and an absurd result that violates the legislative intent in enacting REIT conformity. For these reasons, Appellant's claims should be denied.

I can now accept any questions the panel might have.

JUDGE LEUNG: Thank you, Mr. Havens.

I'll turn to Judge Turner. Any questions for either party?

JUDGE TURNER: I'll start with FTB. Is the essence of the dispute that you think is before us is whether or not the income at issue, which was the subject of the dividends paid deduction, was either included or not?

MR. HAVENS: No, Judge. The specific issue that the FTB sees here is what the -- the tax base is in this case is specific --

JUDGE TURNER: Yeah. Sorry. So within the tax base then, whether or not that income that reflects what the taxpayer took at the federal level as the DPD, whether that's included in the tax base for California purposes or not. Isn't that the -- taxpayer is saying that lacking 25106, they're getting taxed twice. You're saying that application of 25106 means they're getting a double deduction. So isn't the answer then, whether or not we find that the amount of income is either included in the California tax base or not?

MR. HAVENS: Yes, Judge, that is a piece of the -- the puzzle for sure. The Franchise Tax Board's

position is that because federal income, or particularly REIT's taxable income, is directly equated to net income for California purposes for REITs, it must be included in the tax base. That's been reflected in taxpayer's schedules. That's been reflected in the FTB's schedules as well, and that is not in dispute. The question is whether, after that particular starting point is used, a 25106 elimination may be taken on top of it to eliminate the same item of income again.

JUDGE TURNER: Okay. Thank you. That's goods for now.

JUDGE LEUNG: Okay. Judge Lambert, any questions?

JUDGE LAMBERT: Yeah. I just had one question. Just that Appellant was mentioning the TAM 2005-001, and I just want to have clarification that these TAMs were removed from FTB's website, but are they still, like, FTB's interpretations of issues and used internally?

MR. HAVENS: My colleague will take that question.

MS. FRANK: Yeah. Yeah. Thank you for that question, but, you know, it's really not at issue as to whether we're following the TAMs and everything. So in regard to the question of what's at issue here, was the income removed -- that's the prior question -- due to that

dividend paid deduction? And, yes, it was removed, and taxpayer wants to remove the income again with that elimination. So that's -- that's really what's at play here.

JUDGE LAMBERT: Okay. I was just clarifying because the TAM was mentioned, and it seems like something Appellant is relying on. So I was just confirming, even though they were removed, whether it's still something that can be used as, you know, support for FTB's position. But you're saying that's not relevant?

MS. FRANK: Right. Yes.

MR. HAVENS: Judge Lambert, just as a matter of clarification, the proposition that's contained in that particular TAM was subsequently ruled upon by the appellate court in Fujitsu and also in Apple. So those rulings represent the current law on that particular issue.

JUDGE LAMBERT: Okay. Thanks. That's all.

JUDGE LEUNG: Thank you, Judge Lambert.

I have no questions for Franchise Tax Board.

Ms. Freeman, you have eight minutes for rebuttal time.

MS. FREEMAN: Can -- can we take a five-minute break so we can collaborate on the -- the points that we took together first?

JUDGE LEUNG: Okay. See you all back at about 1:25.

MS. FREEMAN: Thank you.

JUDGE LEUNG: Correction. That will 2:25, not 1:25.

(There is a pause in the proceedings.)

JUDGE LEUNG: We're back on the record.

So there's some discussion about a particular exhibit that was not displayed?

MS. FREEMAN: We're good. We'll move on.

JUDGE LEUNG: Okay.

MS. FREEMAN: Is that okay?

JUDGE LEUNG: That's --

MS. FREEMAN: And how much time did I have? 18 minutes?

JUDGE LEUNG: Eight.

MS. FREEMAN: Eight? You told me not to talk fast. Okay.

JUDGE LEUNG: You're doing fine.

CLOSING STATEMENT

MS. FREEMAN: Okay. So some of my comments may not be in any particular order because I took notes as I went.

And respect to the TAM 2005-1, that was Ben

Miller's discussion on the application of Fujitsu. And it is consistent with Young's Market that, basically, whatever dividends you receive, eliminated or not, do increase taxable income. Solely at issue in this case is whether or not the taxpayer's distribution from the REIT -- or sorry -- the TRS to the REIT qualifies for elimination under a plain reading of the statute. There's no need for legislative intent, although there's a plethora of legislative intent here, including the REIC modifications that reflect the dividend was allowed. There was no modification of 25106 when the REIT regime came in play. There was no disallowance of the elimination in the 24872 adoption of the REIT rules.

And even with the REIC was -- regime was determined to be abusive, the legislature changed the REIC rules because they felt it was abusive to disallow the 25106 elimination, but concluded the rules under the REIT regime were not abusive and continue to allow the -- the REIT to deduct the dividend in question as elimination. You have to remember, we have included the REIT income as reported on the federal 1120. We have also added in the TRS for California purposes, which is not in the federal return, into the calculation of taxable income.

We have only eliminated from income once the dividend. And that's because the statute specifically

provides that this dividend, which was paid out of unitary EMP by the TRS to its parent the REIT, shall not be taken into account in determining the tax of any member of the unitary group. Fujitsu makes it very clear the intent was the ability to move EMP from A to B, and it's not taxable income to the group, and shall not cause a tax liability to any member of the group. That's the statute is clear; 24872 is clear.

So we had not modified the calculation of REIT income, that income with the DPD deduction, which is a deduction, not a removal of income. It's a payment that was made to shareholders. Okay. The calculation is based on net taxable income based on 90 percent of line 28, which would not include any removal of payment of a TRS dividend if the TRS was in the REIT return. So even for federal purposes, you would be allowed to take the DPD and separately take the deduction for the TRS dividend for federal purposes had it filed a consolidated return.

We're not dealing with the same item of income. It's not a double deduction. One item is income and an elimination, and it's a nothing. As Ben Miller has said, the dividend elimination is a tax nothing. Okay. That's consistent with the TAM. That's consistent with the statute. So we've taken income that is a nothing because the TRS income has been in the tax base in the current

year and in prior years. And all I'm doing is taking previously taxed income and moving it from the REIT -- sorry -- the TRS to the REIT, which is the absolute intent of 25106. So the income of the TRS is in there for the current year, and the income of the REIT is in the return for the current.

Respondent has indicated you do not modify REIT taxable income. I disagree. You're -- if you're going to take that position in a combined report calculation, what you're telling me is the REIT can deduct income taxes. The REIT can take bonus depreciation. That is absolutely not true. You have to layer on the California modifications to those particular expense deductions in the calculation of the California combined report taxable income. Totally disagree with that analysis.

Now, what you have here is an overlay of a federal concept with combined reporting. There will be differences. Okay. These were all contemplated. The FTB had the opportunity to review subchapter (m) when it was enacted. They had the opportunity when it was modified with the REIC. The legislative did too. They changed nothing. They continue to allow this income, which is a tax nothing, because the TRS is in the group. The income of the TRS is in the group. The dividend distribution merely moves EMP, and all the elimination does is remove

it from the base.

So the DPD deduction itself is a separate issue. I'm allowed a deduction, not a removal of income, based on the amount of distribution to my shareholders. That is the absolute purpose of the REIT regime is to not have the REIT pay tax, right. They're supposed to shift the entire liability to the shareholders. So in this case, the distribution, because it's accumulation of prior year and current EMP of the TRS, in fact, shifts all of the liability from all of the years over to the shareholders, which is the absolute intent of the REIT regime.

They have commented that the REIT is not entitled to any deduction -- is not entitled to a 243 deduction. That's the 24402 deduction for California. There's nothing in there precluding if, in the event, a REIT is in a combined -- in a consolidated return with a TRS from it claiming a 246 deduction, which is payment from the TRS to the parent in a consolidated return. It's a deduction for federal purposes. For us, it's eliminated. Two separate areas of return, super calculation. These are absolute conformity issues and a function of there are disparities between combined reporting and consolidated return reporting and separate reporting.

These are all contemplated when the FTB adopted subchapter (m). These are the consequence of those

decisions. And this itself, if they didn't like the answer, should have either modified it when they adopted the REIC changes to disallow the elimination or should have done, period. End of story. They have not done it. It's clearly allowed because, again, they had to go in and change the statute for REICs. Again, this is not a removal of income. The DPD is not a removal of income. It's a deduction for a payment, right.

Now, the calculation is based on net taxable income, not a specific item of income. So it is a deduction. It's not a double deduction. You have an elimination of income that's been taxed twice. And you have a deduction for an amount paid by the REIT. There's no difference between the amount paid by the REIT for California and federal purposes because, again, it goes into the qualification of the entity as a REIT. A DPD is in the calculation of federal taxable income, which is what he's argued, that it shouldn't have been different. It is in our calculation. We had used the REIT income in the combined report calculation.

The FTB has actually confused what is income with the deduction; two separate things, okay. And, again, the FTB has had -- and the legislature has had numerous opportunities to consider this -- this issue, and has left it as is. This was -- has -- it was brought into the

California Rev & Tax Code, and they had the opportunity to change it. They did not. Again, there's no removal of income. It's a deduction. The DPD is a deduction. The elimination is a tax nothing as Ben Miller would say.

Arguing that we're -- so again, here they would be arguing that we -- we would allow bonus deprecation because you gotta use the federal REIT number. It has to be that number. I disagree. You have to make state modifications for deductions, expenses. And sometimes there's timing issues based on elections but regardless -- and in this case because of the combined reporting, the TRS actually would have paid tax -- because it had taxable income -- but before the fact of the combined report mechanics, which would include a taxable subsidiary that's profitable with another entity that is not.

When you combine the income of the two, sometimes you end up in a net loss. But sometimes you have a high -- for example, you had an income entity in California that operated at a loss high with a factor, and you had an out-of-state company with very high income, when you combine the two, I now have no loss over at this company that lost money. This guy has less money and no factors, and all the tax burden falls on a company that lost money in California.

Here, you have a situation where REITs typically

may lose money unless they sold something because of the depreciation deductions associated with real estate. You now have losses that are transferring over and reducing the taxable REIT subsidiaries' liability. That could have been avoided had they provided that TRSs cannot be combined -- similar to S corps -- with the REIT. They didn't do that. So now you have a situation where the losses are offsetting that income of the TRS and preventing -- creating NOLs and NOL carryovers to the TRS. Those are of absolute functions of combined report mechanics. FTB could address that in the combined report mechanics regs. They didn't. Or they could have addressed it by providing that a TRS is not in the combined report with a REIT.

So now you have a situation where you could have had liability to the REIT on a separate entity basis. And you have the REIT, which is allowed a DPD deduction and not going to pay tax. FTB chose and the legislative chose to combine the two. And the net effect, in this case, is that 25106 applies because I'm eliminating income that's already been included in the measure of tax. And then the DPD, which is a dividend paid deduction -- it's not a removal of income. It's not a double benefit. It's a function of a sanctioned tax preferred structure that says you will pay out 90 percent of your income per year, or

you will not get the benefit of being a REIT.

JUDGE LEUNG: Thank you, Ms. Freeman. I'd like to wrap up in about a minute.

MS. FREEMAN: Okay. And then the other one -- the other one -- the other comment I wanted to make was FTB has cited a number of cases on dividends paid deductions. This is not a dividend paid deduction -- or dividend -- dividends received deductions provisions. This is not a dividend received deduction case. This is an elimination, and the cases that they're citing do not apply in this instance. We have not claimed a double benefit. We've claimed what is exactly permitted under the statute, which is to not double include what is specifically provided in 25106 in the combined report calculation.

We're not removing it from REIT income. This is a combined report calculation that says you take the separate entity, which includes all of the REIT, all the TRS, you add them together, and then you are required to make state modifications for depreciation taxes, basis differences, federal, state conformity, take that number, apportion it out to the respective members of the TRS and REIT, and that's your liability.

So FTB, regardless of the fact that I'm a REIT, I'm allowed a DPD in that calculation of taxable income,

which is a 90 percent deduction of the amount actually paid to my shareholders. And the income that I receive from the TRS is not income. Clearly within its -- that both -- what Ben Miller said in the -- in the Fujitsu decision and in the TAM 2005 and Young's Market is not -- is not income to the group.

JUDGE LEUNG: Thank you, Ms. Freeman.

One last time for my co-panelists.

Judge Lambert, any questions for the parties?

JUDGE LAMBERT: I have no questions. Thanks.

JUDGE LEUNG: Thank you.

Judge Turner, any questions for the parties?

JUDGE TURNER: None. Thank you.

JUDGE LEUNG: Okay. I have no questions also.

We thank the parties for their presentation.

The record is now closed, and the case is submitted.

We will endeavor to issue an opinion in about 100 days. This concludes our hearings for today.

Everybody have a great evening. Thank you.

(Proceedings concluded at 2:39 p.m.)

HEARING REPORTER'S CERTIFICATE

I, Ernalyn M. Alonzo, Hearing Reporter in and for the State of California, do hereby certify:

That the foregoing transcript of proceedings was taken before me at the time and place set forth, that the testimony and proceedings were reported stenographically by me and later transcribed by computer-aided transcription under my direction and supervision, that the foregoing is a true record of the testimony and proceedings taken at that time.

I further certify that I am in no way interested in the outcome of said action.

I have hereunto subscribed my name this 18th day of December, 2025.

_____
ERNALYN M. ALONZO
HEARING REPORTER