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BEFORE THE OFFICE OF TAX APPEALS

STATE OF CALIFORNIA

IN THE MATTER OF THE APPEAL OF,)
LIBERTY MUTUAL GROUP, INC.,) OTA NO. 21129233
APPELLANT.)
_____)

Transcript of Proceedings, taken at
12900 Park Plaza Drive, Suite 300, Cerritos,
California, 90703, commencing at 1:27 p.m.
and concluding at 2:24 p.m. on Thursday,
February 12, 2026, reported by Ernalyn M. Alonzo,
Hearing Reporter, in and for the State of
California.

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APPEARANCES:

Panel Lead: ALJ HUY "MIKE" LE

Panel Members: ALJ CHERYL L. AKIN
ALJ KENNETH GAST

For the Appellant: LINDSAY LACAVA
MARIA EBERLE
DMITRII GABRIELOV

For the Respondent: STATE OF CALIFORNIA
FRANCHISE TAX BOARD

BRIAN BECK
DELINDA TAMAGNI

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I N D E X

E X H I B I T S

(Appellant's Exhibits 1-60 were received into evidence via the Minutes and Orders.)

(Department's Exhibits A-N were received into evidence via the Minutes and Orders.)

O P E N I N G S T A T E M E N T

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1 Cerritos, California; Thursday, February 12, 2026

2 1:27 p.m.

3
4 JUDGE LE: We are opening the record in the
5 Appeal of Liberty Mutual Group, Inc.

6 This matter is being held before the Office of
7 Tax Appeals. The OTA Case Number is 21129233. Today's
8 date is Thursday, February 12, 2026, and the time is
9 1:27 p.m. This hearing is being held in person in
10 Cerritos, California.

11 Today's hearing is being heard by a panel of
12 three Administrative Law Judges. My name is Mike Le, and
13 I'll be the lead judge. Judge Cheryl Akin and
14 Judge Kenny Gast are the other members of this tax appeals
15 panel. All three judges will meet after the hearing and
16 will produce a written opinion as equal participants.
17 Although the lead judge will conduct the hearing, any
18 judge on this panel may ask questions or otherwise
19 participate to ensure we have all the information needed
20 to decide this appeal.

21 Now, for the parties' introductions, for the
22 record, will the parties please state their names and who
23 they represent, starting with Respondent.

24 MR. BECK: Hello. My name is Brian Beck. I'm an
25 attorney for the Franchise Tax Board, which is the

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Respondent.

MS. TAMAGNI: Good afternoon. Delinda Tamagni, Assistant Chief Counsel for the Multistate Tax Bureau for the Franchise Tax Board.

JUDGE LE: Thank you.

And turning to Appellant.

MS. LACAVA: Lindsay LaCava for Appellant Liberty Mutual Insurance Group.

MS. EBERLE: Maria Eberle for Appellant Liberty Mutual Insurance Group.

MR. GABRIELOV: Dmitrii Gabrielov for Appellant.

JUDGE LE: Thank you.

Let's move on to my Minutes and Orders. As discussed with the parties at a prehearing conference on January 16, 2026, and notated in my Minutes and Orders, there are two issues in this appeal. The first is whether Appellant's interest expense deduction is barred by Revenue & Taxation Code section 24425. The second is whether the accuracy-related penalty should be abated. During the parties' presentations, the parties may provide a brief statement outlying the issues on appeal.

Appellant's Exhibits 1 through 60 were entered into the record in my Minutes and Orders. Respondent's Exhibit A through N were also entered into the record in my Minutes and Orders. No witnesses will be testifying at

1 this hearing.

2 After the prehearing conference, Respondent
3 submitted a PowerPoint consisting of two slides. Both
4 parties submitted a list of cases and names to the
5 stenographer, so thank you both. This oral hearing will
6 begin with Appellant's presentation for up to 30 minutes.

7 Before we start with Appellant's presentation, I
8 just want to check to see if there are any questions or
9 comments.

10 Respondent?

11 MR. BECK: No questions. Thank you.

12 JUDGE LE: And turning to Appellant, any
13 questions or comments?

14 MS. LACAVA: No questions. Thank you.

15 JUDGE LE: Thank you.

16 The time right now is 1:30 p.m. Please proceed
17 with your presentation.

18

19 PRESENTATION

20 MS. LACAVA: Good afternoon. May it please the
21 Court, my name is Lindsay LaCava, counsel for Appellant
22 Liberty Mutual Group, which I will refer to as Liberty
23 Mutual.

24 Quite simply, there are two reasons why
25 Section 24425 of the Revenue & Taxation Code cannot apply

1 in this case to disallow the deductions taken by Liberty
2 Mutual for insurance expenses and losses on the
3 extinguishment of debt where Liberty Mutual contributed
4 those borrowed funds to its insurance subsidiaries.
5 First, the expenses at issue are only potentially
6 allocable to Liberty Mutual's dividend income from its
7 subsidiaries. And second, that dividend income is
8 included in the measure of Liberty Mutual's corporation
9 franchise tax.

10 The way the Franchise Tax Board has interpreted
11 and applied section 24425 in this case is simply
12 incorrect. The core facts here are not in dispute.
13 Liberty Mutual owns a group of insurance and non-insurance
14 subsidiaries. For each of the tax years at issue, Liberty
15 Mutual was subject to corporation franchise tax and filed
16 using the combined reporting method that included certain
17 of its unitary affiliates. Liberty Mutual's insurance
18 subsidiaries were properly excluded from its combined
19 California returns because those insurance subsidiaries
20 were subject to and paid California's gross premium tax in
21 lieu of the corporation franchise tax.

22 This case centers around interest expenses and
23 losses on the extinguishment of debt, which I will
24 collectively refer to as interest expenses for ease, that
25 were incurred by Liberty Mutual during the years at issue.

1 After several concessions by the FTB during the briefing
2 process, the interest expenses that remain at issue in
3 this case relate to seven debt issuances and tender offers
4 that were made by Liberty Mutual to unrelated third
5 parties. Liberty Mutual used all or a portion of those
6 debt proceeds to make capital contributions to certain of
7 its insurance subsidiaries. Each of these debt
8 transactions, the use of funds, and the related disallowed
9 interest expense amounts are all summarized and spelled
10 out in Appendix 1 of Appellant's reply brief that was
11 filed on February 20th, 2023.

12 Throughout the tax years at issue, Liberty Mutual
13 received a return on its investment in its insurance
14 subsidiaries in the form of dividends, which Liberty
15 Mutual included in the measure of its corporation
16 franchise tax as reflected on line 4 of Schedule F of
17 Liberty Mutual's California returns. During the period at
18 issue, Liberty Mutual properly deducted the interest
19 expenses at issue for federal income tax purposes under
20 Internal Revenue Code 163. And by virtue of California's
21 conformity to the Internal Revenue Code, Liberty Mutual
22 also deducted the interest expenses at issue for
23 corporation franchise tax purposes. The Franchise Tax
24 Board in this matter has incorrectly asserted that the
25 deductions taken by Liberty Mutual for the interest

1 expenses at issue, should be disallowed under
2 subsection (a) of 24425.

3 So I will turn now to the statutory structure and
4 focus on the proper reading and application of
5 section 24425(a).

6 And since we've lost our demonstrative on the
7 screen, hopefully everyone has it in front of them.

8 I will read the relevant part, which is that no
9 deduction shall be allowed for any amount otherwise
10 allowable as a deduction which is allocable to one or more
11 classes of income not included in the measure of this
12 part -- with this part referring to the California
13 Corporation Franchise Tax Act. The deductions at issue
14 here are the interest expenses related to the debt
15 proceeds that were contributed to Liberty Mutual's
16 insurance subsidiaries. And this case turns on the proper
17 application of the phrase, "Allocable to one or more
18 classes of income not included in the measure of tax."

19 So let's start with the words "class of income."
20 The relevant class of income here is Liberty Mutual's
21 dividend income. As a threshold matter, the class of
22 income to which expenses may be allocable, must be income
23 of the same taxpayer who is claiming the deduction. This
24 is mandated by the overarching statutory structure of the
25 California corporation franchise tax, which computes and

1 imposes tax on each taxpayer separately. And thus, the
2 statutory phrase, "class of income," included in the
3 measure of the tax, necessarily refers to a class of
4 income included in the taxpayer's measure of corporation
5 franchise tax.

6 Decades of prior case law also confirms that the
7 relevant class of income must be income of the same
8 taxpayer seeking to take the deduction. Indeed, every
9 single case concerning Section 24425 that was cited by
10 both Appellants and Respondent in the hundreds of pages of
11 briefing in this case, the class of income at issue was
12 always a class of income of the same taxpayer claiming the
13 deduction. This is also consistent with the purpose and
14 intent of section 24425, which is to prevent a taxpayer
15 from receiving a double benefit. Given this framework,
16 the only relevant class of income to which the interest
17 expenses can potentially be allocable is the dividend
18 income earned by Liberty Mutual as a result of its
19 investments of the debt proceeds in its insurance
20 subsidiaries.

21 In fact, the FTB itself previously agreed with
22 this view in its determination letter issued in the FTB
23 appeals process, which stated that, "Because Liberty
24 Mutual generates income, i.e. dividend income, that is a
25 class of income not subject to the corporation tax law,

1 and the interest expense paid by LMGI and other insurance
2 company subsidiaries is not allowable as a deduction
3 because it is allocable to that class of income," end of
4 quote, which is included in Exhibit 17.

5 The FTB has now asserted a different and
6 incorrect reading of section 24425 arguing that the class
7 of income is somehow the insurance income of the separate
8 insurance subsidiaries. The FTB argues that the interest
9 expenses relate to funds that make the insurance
10 subsidiaries, quote, "Capable of continuing to generate
11 income," end quote, that is not subject to corporation
12 tax. This is directly contrary to prior case law which
13 has recognized the separateness of corporations, including
14 in the context of section 24425. Notably, in Great
15 Western, the California Supreme Court held, quote, "Where
16 there is more than one corporation, they are entirely
17 separate entities for purposes of the California franchise
18 tax. Neither, Revenue & Taxation Code section 24420 or
19 section 24425, purport in any way to effect the entirely
20 distinct and self-sufficient nature of the corporations.
21 It is a fundamental principal of tax law that each
22 taxpayer is accountable and taxable only upon its own
23 income, and may deduct only its own expenses allocable to
24 the earning of such income.

25 I will repeat the key words here. Each taxpayer

1 is accountable and taxable only upon its own income and
2 may deduct only its own expenses allocable to the earnings
3 of such income. Thus, the statute does not allow for the
4 allocation of one corporation's expenses to another
5 corporation's income for purposes of disallowing those
6 expenses under section 24425.

7 If allowed to stand, the FTB's proposed
8 interpretation would create a highly ambiguous and
9 unworkable standard because taxpayers that borrow funds
10 for investment purposes would have to track how investees
11 are using those funds, and whether any income generated is
12 taxable or nontaxable to the investee. The absurdity of
13 the FTB's position is further highlighted by section 244
14 itself, as this reading would make portions of section
15 24425 superfluous. For example, section 24425(b)(1)(A)
16 disallows a deduction for interest expenses paid to an
17 affiliated insurer. Under the FTB screened reading of
18 24425(a), this provision would be unnecessary if the
19 interest expenses could be allocable to the income of the
20 insurance affiliate, which is not subject to corporation
21 tax.

22 Additionally, the FTB's reading would call into
23 question whether premium expenses paid by non-insurers to
24 insurance companies could ever be deducted because the
25 premium income of the insurance company is never subject

1 to corporation tax. So in summary, the only proper and
2 logical reading and application of phrase, "class of
3 income," that is consistent with the structure of the
4 Revenue & Taxation Code and prior precedent is that the
5 interest expenses here are allocable to Liberty Mutual's
6 own dividend income.

7 Next, I will turn to the words, "Included in the
8 measure of the tax." Here, Liberty Mutual's dividend
9 income, which we've established as the class of income at
10 issue, was included in the measure of its corporation
11 franchise tax. Liberty Mutual properly included the
12 dividend income in the computation of its income as
13 reflected on Schedule F, line 4 of its California returns,
14 which are included as Exhibits 3 and 4. The dividend
15 income from the insurance subsidiaries did qualify for a
16 partial 85 percent deduction under section 24410, but the
17 key word here is "partial." Prior case law analyzing
18 section 24425 has only ever disallowed expenses that are
19 allocable to wholly excludable or wholly eliminated
20 income. For example, Great Western involved expenses
21 allocated to dividends that were wholly deductible at the
22 time, and which the court characterized as eliminated and
23 therefore, not subject to the measure of tax.

24 Subsequent California case law, including Zenith,
25 has similarly stated that section 24425 applies only to

1 expenses that produce, quote, "Wholly excludable income."
2 Additionally, prior California Supreme Court and court of
3 appeals cases analyzing the identical phrase included in
4 the measure of tax in a former dividends received
5 deduction statute also concluded that amounts that are
6 offset by a partial deduction are indeed included in the
7 measure of the tax.

8 Lastly, the FTB seemingly acknowledges on page 23
9 of its additional brief, that the recent Minnesota Beet
10 and nonprecedential Microsoft decisions issued by this
11 Office of Tax Appeals also support a distinction between
12 income that is wholly eliminated versus income that is
13 subject to a partial deduction.

14 So in conclusion, the dividend income from the
15 insurance subsidiaries was included in the measure of tax,
16 notwithstanding the partially offsetted -- offsetting
17 deduction, and 24425(a) does not apply. This analysis of
18 the plain language of the statute is also consistent with
19 the overarching intent of section 24425(a). The clear
20 purpose and intents of this provision is to prevent
21 taxpayers from receiving a double benefit. The classic
22 example would be borrowing funds and taking interest
23 deductions to purchase municipal bonds that then generate
24 tax exempt income again to the same taxpayer. There is no
25 double benefit here.

1 Liberty Mutual borrows money from third parties.
2 It contributes the funds to its insurance subsidiaries.
3 Liberty Mutual then earns a return on that investment in
4 the form of a dividend, which is then subject to
5 California corporation franchise tax. Application of
6 section 24425 to deny the interest expense deductions to
7 Liberty Mutual would result in double taxation to Liberty
8 Mutual. First, it would be taxed on its disallowed
9 deduction for the interest payment; and second, it would
10 be taxed on the dividend income that it then earns from
11 its insurance subsidiaries. And this double taxation is
12 then compounded by a third layer of taxation when the
13 insurance affiliates pay premium tax on the income from
14 their insurance business. Thus, the FTB's position would
15 lead to an outcome that is directly contrary to the
16 purpose of section 24425. This concludes my discussion of
17 why section 24425 does not apply to disallow Liberty
18 Mutual's interest expense.

19 And so I would like to turn now to why the
20 imposition of an accuracy-related penalty is not
21 appropriate in this case. As you know, penalties cannot
22 apply when a taxpayer has substantial authority for its
23 tax treatment; second, when the taxpayer's position was
24 adequately disclosed in the return and there is a
25 reasonable basis for the tax treatment; or thirdly, where

1 the taxpayer acted with reasonable cause and good faith.
2 Penalties must be abated if any one of these elements are
3 met, and all three elements apply to prevent the
4 imposition of a penalty here.

5 First, turning to substantial authority, there is
6 substantial authority for the tax treatment of an item if
7 the weight of the authority supporting the taxpayer's
8 treatment is substantial in relation to the weight of the
9 authority supporting contrary treatment. As outlined in
10 my prior remarks and the hundreds of pages of briefing in
11 this case, Liberty Mutual relied on the plain statutory
12 language case law and overarching purpose of section 24425
13 in determining the treatment of the interest expenses on
14 its tax return. Importantly, a taxpayer does not need to
15 prevail in litigation to have substantial authority.
16 Thus, Liberty Mutual had substantial authority to deduct
17 the interest expenses on its returns regardless of the
18 ultimate outcome of this case.

19 Next, turning to adequate disclosure, Liberty
20 Mutual adequately disclosed the interest expense
21 deductions on Schedule A of its Form 100W. Other
22 tribunals have found that displaying a deduction on the
23 return is sufficient disclosure under a similar standard.
24 And I refer you to the Stewart's Shops case cited in our
25 briefs. Moreover, the reasonable basis standard is lower

1 than the substantial authority standard that we just
2 discussed. So it's necessarily met for all the same
3 reasons that the substantial authority stand is met.
4 Thus, Liberty Mutual adequately disclosed its interest
5 expense deductions on its return and had a reasonable
6 basis for the position.

7 Lastly, turning to reasonable cause and good
8 faith, the penalty does not apply to any portion of an
9 underpayment where the taxpayer acted with reasonable
10 cause and in good faith. A reasonable cause determination
11 takes into account all of the pertinent facts and
12 circumstances. Here, Liberty Mutual made substantial
13 efforts to determine its correct corporation franchise tax
14 liability, ultimately relying on statutes, case laws, and
15 the other authorities discussed in deducting its interest
16 expenses. This is further demonstrated by the fact that
17 many of the deductions that were originally denied by the
18 FTB on audit were ultimately conceded throughout this
19 process. Thus, Liberty Mutual had reasonable cause and
20 acted in good faith in deducting its interest expenses.
21 For these reasons, substantial authority, adequate
22 disclosure and reasonable basis, and reasonable cause in
23 good faith penalties cannot apply.

24 So in summary, Section 24425 of the Revenue & Tax
25 Code cannot apply to disallow the interest expense

1 deductions at issue in this case because first, the
2 interest expenses at issue are only allocable to Liberty
3 Mutual's dividend income from its insurance subsidiaries;
4 and that dividend income is included in the measure of
5 Liberty Mutual's corporation franchise tax. This is why
6 Liberty Mutual must prevail.

7 And at this time, I welcome any questions that
8 you may have.

9 JUDGE LE: Thank you so much for your
10 presentation.

11 Let me turn to the panel to see if they have any
12 questions.

13 Judge Akin, any questions?

14 JUDGE AKIN: Let me try that again. Thank you.
15 No questions from me at this time.

16 JUDGE LE: Thank you.

17 Turning to Judge Gast, any questions?

18 JUDGE GAST: Same. No questions at this time.
19 Thank you.

20 JUDGE LE: Okay. So now its Respondent's turn.

21 You have up to 30 minutes, and we're starting at
22 2:00 p.m. Please proceed. Thank you.

23

24 PRESENTATION

25 MR. BECK: Good afternoon. I'm Brian Beck,

1 attorney for Respondent Franchise Tax Board, and with me,
2 Delinda Tamagni, Assistant Chief Counsel of the Multistate
3 Tax Board -- Multistate Tax Bureau.

4 JUDGE LE: If you can, can you move your
5 microphone a little bit more closer to you.

6 MR. BECK: I'm sorry.

7 JUDGE LE: And make sure it's turned on.

8 MR. BECK: There you go.

9 Appellant Liberty Mutual Group, Inc., borrowed
10 funds and contributed the funds to insurance subsidiaries.
11 The insurance subsidiaries were tax exempt. Appellant
12 deducted the interest expense. Because Revenue & Taxation
13 Code R&TC section 24425 disallows double tax benefits,
14 Respondent disallowed expense deduction. Appellant has
15 not established entitlement to this interest expense
16 deduction and, therefore, Respondent's disallowance was
17 proper.

18 There are two issues. The first issue is, has
19 Appellant shown that it is entitled to the identified
20 interest expense deductions after application of R&TC
21 section 24425. The second issue is, has Appellant shown
22 that the accuracy-related penalty should be abated.
23 Appellant is the parent company for the sixth largest
24 property and casual insurer in the world. Under
25 principles of unity, Appellant, together with its

1 subsidiaries, would be considered a single entity and
2 combined into a combined reporting group for certain tax
3 computations. For convenience, I will call the combined
4 reporting group the combined group or the taxable group.

5 Unity means the entities have such a close
6 connection, they are treated as parts of the same unitary
7 business. Insurance companies are exempt from tax under
8 Article 13, Section 28 of the California Constitution.
9 Unity is relevant here because it chose a tax benefit from
10 this insurance exemption. There's a difference between
11 unitary group and combined group. Exempt organizations
12 are part of the unitary group, but are not included in the
13 combined group. If you imagine a circle representing the
14 unitary group, the combined group is a concentric circle
15 within that circle. The combined group is just the
16 taxable subsidiaries.

17 Appellant had an unitary group, including many
18 insurance subsidiaries but a much smaller combined group.
19 Again, as we'll see, there was a tax benefit and that all
20 the insurance company subsidiaries were removed from the
21 combined group. As some indication of the size of
22 Appellant's unitary group, Respondent has provided
23 Exhibit G, which is copies of several national
24 associations for insurance commissioners and AIC forms
25 from some insurance subsidiaries. The forms have

1 organizational charts with over 100 entities.

2 I'm now going to review some of the facts which
3 suggest that Appellant is unitary with the insurance
4 subsidiaries. Appellant's 2011 annual review, like an SCC
5 Form 10-K, which is our Exhibit A, had financial
6 statements referring to the unitary group on a worldwide
7 consolidated basis, including both the combined group and
8 the insurance subsidiaries. The annual review had a
9 summary of the year's operations on a worldwide
10 consolidated basis; again, including the insurance
11 subsidiaries. As far as back the 2003 annual review, the
12 Appellant referred to a single high-performance standard
13 for its employees everywhere. When a person in any part
14 or level of the company picks up the phone and says,
15 "Liberty Mutual, how can I help you," they both mean it
16 and have the skills and technology to do it. Appellant
17 uses a stylized depiction of the Statue of Liberty as its
18 trademark. The worldwide headquarters for the group,
19 including both the taxable group and the insurance
20 subsidiaries, was in a single building, 175 Berkeley
21 Street in Boston, but in essence moved to the eponymous
22 Liberty Mutual Tower at 157 Berkeley Street.

23 From 2003, Appellant managed the retirement
24 benefit plan, the Employees Thrift Incentive Plan to
25 supplemental income at retirement plan, and the medical,

1 dental, and life insurance plans post-retirement, covering
2 all U.S. employees of both the combined group and the
3 insurance subsidiaries who met certain eligibility
4 requirements. There were earnings calls where they
5 discussed the entire business, and that's our Exhibit K.
6 The combined group performed management services for the
7 insurance subsidiaries under an intercompany management
8 services agreement, which is our Exhibit I.

9 The combined group performed various asset
10 management services for the insurance subsidiaries, and
11 that is on an SCC Form 13F filing, Exhibit L. And the
12 loans are an example of intercompany financing where the
13 entire unitary group's credit was used to benefit members.
14 On its 2011 California tax return, Appellant reported
15 approximately \$5 billion in gross income for California
16 purposes on a water's-edge basis, which means limited to
17 U.S. domestic entities, primarily from investment income.
18 This was just a taxable combined group without the
19 insurance subsidiaries. The 2011 annual review reported
20 worldwide consolidated revenues of \$34.7 billion,
21 including the insurance subsidiaries. The NAIC statements
22 reported approximately \$17 billion of gross income from
23 the domestic insurers listed. Both numbers are
24 substantially higher than \$5 billion. So billions of
25 dollars of exempt income was removed from the combined

1 report. We don't know the exact amount as it was
2 unnecessary to report it.

3 Now that we've discussed Appellant's unitary
4 group, we will move on to the loans. As mentioned,
5 Appellant borrowed funds and contributed the proceeds to
6 insurance subsidiaries. Audit division denied the
7 interest expense deductions. As for briefing, the parties
8 agree on the loans at issue. As an example, the 2007
9 Offering Memorandum, which is our Exhibit E, reports that
10 the proceeds of the loans would be used for the insurance
11 subsidiaries and describe the business as the premiere
12 property and casualty insurer. Further, the same
13 documents said that the ability of the insurance
14 subsidiaries to issue dividends was limited, as they
15 needed approval from regulators. In the IDR 014 response,
16 our Exhibit D, the auditor provided a list of loans to
17 Appellant and requested that Appellant confirm the
18 proceeds were contributed to insurance subsidiaries. In
19 response, Appellant confirmed each.

20 We've discussed the background of the case, and
21 we're now moving on to the argument. The Court of Appeal
22 in Metropoulos referred to the principle that deductions
23 are a legislative grace, and the taxpayer must prove
24 entitlement to the deduction. Moreover, deductions are
25 construed against the taxpayer. In Great Western

1 Financial, the Supreme Court held that the taxpayer must
2 prove that R&TC section 24425 does not apply. Appellant
3 has not shown that it's entitled to the interest expense
4 deductions. The interest deductions are disallowed under
5 R&TC section 24425 because Appellant borrowed funds and
6 contributed them to exempt insurance subsidiaries.

7 And we -- I would ask you to look at our Slide 1,
8 but we have our printout. So R&TC section 24425 states,
9 "No deduction shall be allowed for any amount otherwise
10 allowable as a deduction, which is allocable to one or
11 more classes of income not included in the measure of tax
12 imposed by this part."

13 I will now take a closer look at the allocation
14 to one or more classes, and not included in the measure of
15 tax parts, in order. First, we're looking at allocation.
16 R&TC section 24425 refers to a deduction allocable to one
17 or more classes of income. The deduction is allocated to
18 the income of the insurance subsidiaries. Alternatively,
19 it could be allocated to the dividends Appellant received
20 from insurance subsidiaries with the same result.

21 Allocation generally means an association between expense
22 and income, an assignment based on a connection between
23 different groups. The interpretation is not limited to a
24 particular form of accounting, although cost accounting
25 has a developed practice of assigning cost centers to

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business units.

The allocation here is taking an expense and assigning it to a profit center. For example, the salary of financial analysts making investment decisions on purchasing taxable publicly traded stock, this expense would be assigned to taxable investing. It is not assigned to the operating income of the insurance subsidiaries, and we are considering the interest expense from loans which are contributed to the insurance subsidiaries in order to grow those businesses. Treasury Regulation section 1.265-1C is a relevant source. Briefly, the Regulation states expenses directly allocable to a class of exempt income shall be allocated there too. If the expenses are indirectly allocable, the Regulation requires using a reasonable proportion based on the facts and circumstances. Thus, R&TC section 24425 contemplates a factual inquiry to trace direct expenses to a specific class of income. The factual inquiry has been described as finding a dominant purpose.

In any case, a taxpayer must make an evidentiary showing before direct allocation to a taxable purpose. Indirect expenses are assigned by ration. In Zenith, FTB used an indirect allocation, not direct. In Zenith, FTB did not identify which specific loan proceeds were used to buy which specific stock. In fact, the Zenith decision

1 cite the offering brochure to the debenture that did not
2 require the funds to be contributed to an insurance
3 subsidiary.

4 Here, in the present case, audit identified
5 specific loan proceeds which were contributed to exempt
6 subsidiaries based on the offering documents and other
7 statements. In Exhibit D, Appellant confirmed the
8 assignment. Thus, the identified interest expense was
9 directly allocable to the income of the insurance
10 subsidiaries. In Zenith, except for one year, the
11 taxpayer used direct tracing to assign the interest
12 expense to a taxable activity. Here, Appellant did no
13 tracing, only Respondent has traced. In that one
14 exception year in Zenith, the taxpayer did not meet its
15 burden of proof. Notably, in the final year the taxpayer
16 contributed some amount to an insurance subsidiary. In
17 that year, FTB's ratio was used based on facts and
18 circumstances, which is an indirect allocation. So Zenith
19 confirms that Respondent's tracing, a direct allocation,
20 is appropriate here. The interest expense is allocated or
21 assigned to the income from the insurance subsidiaries.

22 Appellant claims that an allocation cannot be
23 made to the income of the insurance subsidiaries.
24 Appellant is not correct. The loans were used to
25 contribute to the insurance subsidiaries. Unlike the

1 taxpayers in Zenith and Great Western, Appellant did not
2 borrow the money specifically to acquire dividend-bearing
3 stock. Appellant wanted to grow the business of the
4 insurance subsidiaries. The allocation is the strongest
5 most persuasive connection between an expense and a class
6 of income.

7 Appellant has claimed Respondent did not identify
8 a reported case where the allocation is to the income of
9 the insurance subsidiaries as though this should
10 disqualify the allocation. That is not material. Rather,
11 Appellant is unable to identify a situation where a
12 taxpayer borrows money specifically to contribute to
13 exempt subsidiaries and the deduction is allowed.
14 Instead, the precedent, such as Zenith, suggests that
15 Appellant must provide evidence to refute the direct
16 allocation to nontaxable income, and then Appellant must
17 justify an allocation by ratio. Appellant also argues
18 that Respondent is shifting income to a different
19 taxpayer. Appellant refers to dicta in Great Western. It
20 is a fundamental premise of tax law that each taxpayer is
21 accountable and taxable only upon its own income and may
22 deduct only its own expenses allocable to the earnings of
23 such income. Combined reporting is one identified
24 exception to this principle.

25 The Court of Appeals decision in Handlery opened

1 by quoting the sentence. The Handlery decision was
2 premised on interstate combined reporting being an
3 exception. It took only a single year as Great Western
4 was issued in 1971, and Handlery was issued in 1972.
5 Moreover, R&TC section 25102 authorizes Respondent to
6 allocate income among different persons as though they
7 were one person. And, again, the present case involves a
8 contribution to unitary subsidiaries. Summarizing
9 allocation to class of income, Appellant needed to show
10 that the loan proceeds were used for a taxable purpose.
11 Instead, Respondent has specifically traced the funds to
12 contributions used to grow the business of exempt
13 subsidiaries.

14 Now, I will talk about the "included in the
15 measure of tax," the next phrase in the statute. R&TC
16 section 24425 refers to class of income as being not
17 included in the measure of tax. Appellant claims that the
18 income in question was included in the measure of tax. In
19 other words, Appellant claims that either the income of
20 the insurance subsidiaries or the insurance dividends have
21 already been taxed under the California corporate income
22 tax. Neither of these claims are true. Appellant is the
23 parent company to the sixth largest property and casualty
24 insurer in the world. Appellant would have billions more
25 in gross income if the insurance subsidiaries were

1 taxable. We don't know the exact amount because it was
2 unnecessary to report this information.

3 Appellant claims that the class of income has to
4 be to the insurance dividends, but also, that the
5 insurance dividends are included in the measure of tax.
6 In both Zenith and Great Western, dividend subject to a
7 dividends received deduction, a DRD, were not included in
8 the measure of tax. So Appellant is simply not correct
9 that an item subject to a DRD is included in the measure
10 of tax. In response, Appellant claims that a deduction
11 must be wholly deductible in order to not be included in
12 the measure of tax. Thus, according to Appellant, if the
13 item is subject to an 85 percent deduction, it is included
14 in the measure of tax. But if the DRD is 100 percent, it
15 is not. This is also incorrect. The text simply says
16 "not included." There's no limitation. Great Western
17 financial explains that this means under any authority for
18 any purpose. The principle of reading the statute against
19 a deduction would suggest that there is not a limitation
20 only for 100 percent deductions.

21 Furthermore, Appellant is improperly adding
22 language from a different statute. The parallel federal
23 statute, IRC section 265(a)(1), uses the phrase, "wholly
24 exempt." R&TC section 24425 does not use "wholly exempt."
25 Appellant assumes that R&TC section 24425 must be read as

1 though it also uses the phrase "wholly exempt." Based on
2 Commissioner v Asphalt Products, the U.S. Supreme Court
3 would say the language of the statute lacking the
4 additional text is clear and needs no other
5 interpretation. It is impossible to further explain the
6 statute without repeating its language.

7 Furthermore, the insurance dividend statute, R&TC
8 section 24410, implies that R&TC section 24425 ordinarily
9 can apply to partial DRDs. It prevents -- the insurance
10 dividend statute prevents R&TC section 24425 from applying
11 during a transition period. The DRD was 80 percent during
12 this transition period. If R&TC section 24425 did not
13 apply to partial dividends, why would the legislature need
14 to create a special exception to prevent R&TC section
15 24425.

16 JUDGE LE: I'm sorry. Can you slow down just a
17 little bit. I --

18 MR. BECK: Oh, I'm sorry.

19 JUDGE LE: Thank you.

20 THE HEARING REPORTER: Just with the numbers.

21 MR. BECK: Oh, the numbers. My bad. My bad. A
22 lot of 24425s. So let's see.

23 The DRD was 80 percent during this transition
24 period. If R&TC section 24425 did not apply to partial
25 dividends, why would the legislature need to create a

1 special exception to prevent R&TC section 24425 from
2 applying?

3 Finally, if OTA finds the text ambiguous, Anaheim
4 Union Water suggests that the interaction of two statutes
5 might resolve the ambiguity. The legislature could have
6 made the deduction limited to 85 percent or 100 percent.
7 The legislature chose 85 percent, which is less than 100
8 percent. Did the legislature choose only 85 percent in
9 order to enhance the deduction? The legislature did not
10 intend, by limiting the deduction to 85 percent for
11 taxable companies to incur interest expense, that they
12 would have disallowed if the DRD was 100 percent. To
13 summarize the application of the statutory language on
14 included in the measure of tax, the income of the
15 insurance subsidiaries is not included in the measure of
16 tax because they are exempt. Likewise, the insurance
17 dividends are not included in the measure of tax because
18 they are subject to a DRD. Consequently, Appellant has
19 failed to show that R&TC section 24425 does not apply to
20 disallow the interest expense deductions.

21 We have just discussed R&TC 24425
22 subdivision (a). Appellant claims that R&TC section 24425
23 subdivision (b) should apply instead, and this argument is
24 not persuasive. Appellant's argument is based on
25 California Code of Civil Procedure section 1859, which is

1 a canon of construction that specific provisions govern
2 general provisions where the provisions are inconsistent.
3 And let me repeat that, where the provisions are
4 inconsistent. Subdivision (a) and subdivision (b) cannot
5 be inconsistent. Both disallow a deduction. Two separate
6 provisions can disallow a deduction, and that is not
7 inconsistent. The provisions would be inconsistent if
8 under the same circumstances one granted a deduction and
9 the other disallowed it. In that case, whichever was more
10 specific would govern when the two were inconsistent.

11 The fact that there can be no inconsistency
12 between two disallowances is sufficient. Nevertheless, I
13 will explain how subdivision (a) and subdivision (b) cover
14 different situations and are complementary, not
15 contradictory. Subdivision (a) looks at the allocation of
16 an expense to a class of income. If the expense is for
17 nontaxable income, the deduction is disallowed.
18 Subdivision (b) looks at the income, not the expense. It
19 applies to a different situation, essentially, a general
20 corporation borrowing from an insurance subsidiary, even
21 if the borrowing is for a taxable purpose.

22 I will go over a hypothetical to explain.
23 Suppose a large general corporation has a captive insurer.
24 The captive insurer is an exempt insurer. The captive
25 insurer lends money to a corporation. The corporation

1 uses the loan proceeds for its taxable business and
2 deducts the interest expense. Subdivision (a) involves an
3 allocation of expense to an item of income. The money was
4 borrowed to spend on the taxable business. Thus,
5 subdivision (a) would not disallow this. Unlike
6 subdivision (a), subdivision (b) does not look to how the
7 expense is allocated. Instead, it looks at whether the
8 loan would generate income for the captive insurer if the
9 insurer were not exempt.

10 Appellant claims that only subdivision (b)
11 applies in the insurance context. Yet, as noted in the
12 original briefing, R&TC section 24410 sub -- 2441
13 subdivision (b) (5) holds that R&TC section 24425 does not
14 apply in a transition period, and it refers to dividend
15 income in subdivision (a). Why prevent something from
16 happening if it could never happen in the first place?
17 Further, the legislature affixed a terminal date to the
18 grace period on R&TC section 24425, which suggests that
19 section may apply once the grace period has elapsed. In
20 sum, with respect to Appellant's argument on R&TC
21 section 24425 subdivision 9(b), the legislature wanted to
22 disallow deductions from this different situation in
23 addition to the situations where deductions were already
24 disallowed. And subdivision (b) is irrelevant to the
25 present case, and is inconsistent with subdivision (a).

1 And moving on to Issue 2 on -- I'll have you look
2 at the second slide, which is about the accuracy-related
3 penalty.

4 So the ARP was imposed because there was a
5 substantial understatement of tax, and the penalty is not
6 shown, the penalty should be abated. R&TC section 19164
7 conforms to the relative IRC provisions, Internal Revenue
8 Code, IRC section 6662 and 6664 and the regulations
9 promulgated thereunder. This is summarized in Appeals of
10 Lovinck Investments. In both years Appellant paid under
11 \$10,000 with the return. The understatement, after
12 concessions, is in the hundreds of thousands. Thus, the
13 substantial understatement requirement is met. Appellant
14 can reduce the penalty by the proportion attributable to
15 an item if there is substantial authority for that
16 treatment if there is a reasonable basis with adequate
17 disclosure, or if there is reasonable cause and good
18 faith. For disclosure, the Treasury Regulations require
19 disclosure on a Form 8275.

20 Appellant did not meet substantial authority.
21 There is no authority supporting the position that a
22 taxpayer can borrow money and use it for an exempt purpose
23 and take an interest deduction. In comparison, Zenith
24 involved at least an allocation by ratio between taxable
25 and nontaxable. The tax -- the taxpayer did a direct

1 allocation under IRC Section 265(a) and the Treasury
2 Regulations identifying a taxable purpose in connecting
3 the expense to the purpose. Appellant did not do that
4 here. In Zenith, FTB did a reasonable fact-based
5 allocation between taxable and nontaxable purposes.
6 Appellant did not do that either.

7 Appellant claims the funds were spent entirely on
8 a taxable purpose, even though the offering documents for
9 the loans stated they would be used for an exempt purpose.
10 No authority supports this position. Appellant has not
11 satisfied the requirements for reasonable basis for the
12 same reasons, and there's not authority supporting its
13 filing position. Further, Appellant also does not have
14 adequate disclosure because there was no Form 8275.
15 Appellant did not meet the good faith and reasonable cause
16 standard because there was no disclosure. Additionally,
17 Appellant did not attempt to allocate between taxable and
18 nontaxable purposes. Appellant has not found an example
19 that supports classification that this is reasonable
20 cause. Respondent made concessions to facilitate
21 resolution of the case. For penalty abatement, we're
22 looking at Appellant's position at the time of filing.
23 Respondent's good faith during the appeals process is
24 irrelevant.

25 In conclusion with regard to Issue 1, Appellant

1 borrowed funds expressly to contribute them to exempt
2 insurance subsidiaries. Appellant has not established
3 that it was entitled to a deduction that R&TC section
4 24425 subdivision (a) does not disallow the interest
5 expense. For Issue 2, Appellant made a substantial
6 understatement of tax, and Appellant has not established
7 grounds for abatement of the penalty.

8 Thank you, and I'd be happy to answer any
9 questions if you have any.

10 JUDGE LE: Thank you so much for your
11 presentation.

12 Let me turn to Judge Akin. Any questions?

13 JUDGE AKIN: Judge Akin speaking. I do have one
14 question, and I plan to pose it to Franchise Tax Board,
15 but then give Appellant also an opportunity to respond as
16 well. So focusing this moment on the measure of tax
17 question, and assuming for this question that the
18 dividends are allocable -- excuse me -- that the interest
19 deduction is allocable to the dividends, is the 15 percent
20 of the insurance dividend income company that is not
21 subject to that 85 percent dividend received deduction
22 included in the measure of tax?

23 If you need me to repeat anything, just let me
24 no.

25 MR. BECK: I -- I follow. So first, this has --

1 wasn't briefed by the parties, and it wasn't raised by
2 Appellant. So I'm -- we -- we haven't fully explored this
3 issue. I would point out that -- if you'd actually look
4 at the text of 24425, which is our slide 1 again, it says,
5 "No deduction shall be allowed for any amount" -- "any
6 amount." And there is a precedential State Board of
7 Equalization opinion in San Antonio Water Company, which
8 disallowed for any amount. It did not allow the partial
9 deduction.

10 JUDGE AKIN: Okay. Thank you.

11 And, Appellant, did you want to respond, and do
12 you want me to repeat the question I had asked?

13 MS. LACAVALA: Thank you. We would like to
14 respond, and we do not need to have the question repeated.

15 I would refer the panel to Liberty Mutual's tax
16 return, which is in evidence as Exhibits 3 and 4 for the
17 two tax years at issue. The dividend income is clearly
18 included in the computation of income as reflected on
19 line 4 of Schedule F. That includes 100 percent of the
20 dividend amount. While a portion was subject to an
21 offsetting deduction, the remaining 15 percent is
22 obviously not. And as we previously stated, included in
23 the measure of tax does not look to post deductions. It
24 looks to how much was included in the original computation
25 as supported by the case of Rosemary California Supreme

1 Court Case and Green Investments, both interpreting the
2 phrase, including -- included in the measure of tax to
3 mean gross income.

4 JUDGE AKIN: Okay. Thank you. That's my only
5 question at this point.

6 JUDGE LE: Thank you.

7 Let's turn to Judge Gast.

8 Any questions?

9 JUDGE GAST: This is Judge Gast. I'll wait until
10 the end. Thank you.

11 JUDGE LE: All right. So now its Appellant's
12 turn for its presentation.

13 Appellant, are you ready to proceed with your
14 rebuttal statement?

15 MS. EBERLE: Yes, Your Honor. Thank you.

16 Can you all hear me okay?

17 JUDGE LE: Great. Thanks.

18

19 CLOSING STATEMENT

20 MS. EBERLE: As Attorney LaCava stated earlier, I
21 think this is a fairly simple cases that, unfortunately,
22 has been complicated by hundreds of pages of briefs. But
23 I think we get down to the core issue, and there's just a
24 few things I'd like to point out in response to the things
25 that have been said by Respondent here today.

1 I think the first thing this is, this is very
2 clearly a simple question of are the deductions that we're
3 talking about allocable to a class of income that hasn't
4 been subject to tax, right. It's very simple. It's all
5 about the same taxpayer. Respondent would like us to
6 believe that we need to walk across the aisle to someone
7 that is not subject to the same tax to find a class of
8 income that somehow has not been subject to tax.

9 Respondent also paints an interesting picture
10 brining us into the unitary business principle. I don't
11 wish to take us there because it's a red herring and
12 quite, frankly, it's irrelevant. Appellant has not never
13 contested the fact that we are engaged in a unitary
14 business, and we have no intention to do so. However,
15 Respondent attempted to characterize the operations of our
16 unitary business by saying things like, "The insurance
17 companies are not taxable." "They're exempt from tax," I
18 think was the phrased that was used. "They're actually
19 subject to a premium tax." There were also insinuations
20 that billions of dollars of income were, I think, in
21 quote, "Removed from the tax base." That was done by
22 operation of law.

23 The California taxation system requires that
24 non-insurance companies file one set of returns, while
25 insurance companies file other set of returns. So the

1 taxpayer did no such thing as remove income from a tax
2 return, right. So all of those insinuations and all of
3 that, I think, speculation with respect to the unitary
4 business principles are irrelevant here. As Ms. LaCava
5 pointed out earlier, all of the authorities on point in
6 this matter, directly involve income and expenses of the
7 same taxpayer. To suggest otherwise would lead down a
8 path of absurdity that I just don't feel taking us down.

9 I think some of the other themes that we heard
10 sort of suggested here today involve, again, the fact that
11 a DRD -- a partial DRD somehow means that something is no
12 longer subject to tax. The statutory language here -- I
13 think also as pointed out by Respondent -- is pretty black
14 and white. Something is either included, or it isn't. In
15 this case, income is included, right. The income to
16 which -- the only income to which those expenses can be
17 allocated. So I just urge this panel to think about the
18 simplicity as I know you know of this case.

19 And when it comes to penalties, I think the
20 important thing to remember is that it's an "or" test, and
21 the statutory language is very much in favor. The plain
22 meaning, actually, of a statutory language is very much in
23 favor of Appellant in this case. It is very clear that
24 Liberty Mutual deducted expenses that are allocable to a
25 class of income that is included in its tax base. That is

1 what's required here, required by every single authority
2 that's been cited in the briefs, and there has been no
3 authority cited by the other side to the contrary.

4 So thank you.

5 JUDGE LE: Thank you for your final statements.

6 Let me turn it back now to Respondent Franchise
7 Tax Board for rebuttal statements.

8 MR. BECK: Thank you.

9

10 CLOSING STATEMENT

11 MR. BECK: So just to sort of summarize our
12 position, Appellant failed to establish that it was
13 entitled to the interest expense deductions. As provided
14 in Great Western, Appellant had to show that R&TC
15 section 24425 does not disallow the deduction. The
16 interest expense is allocated to the operating income of
17 the insurance subsidiaries. The allocation is simply the
18 most direct persuasive connection between the expense and
19 income. The allocation was made based on the evidence of
20 the offering documents and Appellant's agreement as to the
21 use of the funds. The insurance subsidiaries were
22 unitary, shared the same office building, Appellant
23 managed the retirement plans, and so on. That class of
24 income is not included in the measure of tax because of
25 the constitutional insurance exemption.

1 Alternatively, the interest expense could be
2 allocated to the insurance dividend income. That class of
3 income is not included in the measure of tax because like
4 the dividends in Great Western and Zenith, they are
5 subject to a DRD. Appellant's claim that they must be
6 subject to a 100 percent deduction are not supported by
7 statutory interpretation or context.

8 Finally, Appellant is subject to the ARP because
9 of substantial understatement because Appellant has not
10 found any authority that permits interest expense
11 deductions for amounts contributed to an exempt insurance
12 subsidiary; Appellant has not found authority to abate the
13 penalty, nor did Appellant properly disclose the position
14 on a Form 8275.

15 And in regards to Appellant's claims that the
16 income of the insurance subsidiaries was included in the
17 measure of tax, I would point to -- on our slide 1, the
18 text of R&TC section 24425, which limits -- it's not
19 included in the measure of the tax imposed by this part,
20 and the tax on insurance companies is not imposed by this
21 part.

22 So in sum, OTA should find for Respondent on both
23 issues, and that's all I have.

24 JUDGE LE: Thank you for your statements.

25 Let's finally turn back to Appellant for its

1 closing statements. You have five minutes.

2 MS. LACAVA: Well, thank you. I'll turn on
3 microphone. How about I'll do that, then that will be --

4 JUDGE LE: That's helpful.

5 MS. LACAVA: We've had enough technology issues
6 today, right.

7

8 CLOSING STATEMENT

9 MS. LACAVA: Again, I think -- again, just to
10 keep this as simple as possible -- the issue here is
11 whether Liberty Mutual was entitled to take deductions of
12 interest expenses. The only class of income to which they
13 can be attributable because it have to -- it has to be
14 Liberty Mutual's income, right, is the dividend income
15 that it received from its insurance company subsidiaries.
16 I think Appellant understands that we bear the burden of
17 proof in this case. Again, I don't think there's a
18 question on that. I don't think Appellant disputes the
19 fact that we are part of a unitary business with our
20 insurance subsidiaries.

21 The fact of the matter is we borrowed money,
22 right. No one has denied that fact. The money was
23 contributed to insurance subsidiaries. No one has denied
24 that fact, right. The question really is just, is there
25 income in the measure of tax which those expenses can be

1 attributed? And it very clearly is within the measure of
2 tax. All the precedential authorities in California all
3 say, right, that something is included in the measure of
4 tax, if a portion of it is included in the measure of tax.

5 And quite frankly, this Board has recently
6 concluded the say. So thank you.

7 JUDGE LE: Thank you so much for your closing
8 statement.

9 Let me turn to the panel one last time for any
10 final questions.

11 Judge Akin, any final questions for either party?

12 JUDGE AKIN: No additional questions from me, but
13 I did want to thank both parties for their time today and
14 for bearing with us with some of our technical
15 difficulties. So, thank you.

16 JUDGE LE: Judge Gast, any final questions for
17 either party?

18 JUDGE GAST: Yeah, I have a few questions.
19 They'll be brief, hopefully.

20 This one is for Appellants.

21 So R&TC section 24410(b)(5) says that 24425
22 doesn't apply for certain years, and it makes no reference
23 to that section for other years. So isn't there -- can't
24 you infer that it does apply for these years because it
25 doesn't apply for certain years you make election.

1 MS. EBERLE: So, well, I think the first thing
2 that I point out is that the legislative history actually
3 expressly states we are to make no inference with respect
4 to that provision. And I think there's -- so I think if
5 we -- what's really important is sort of set the stage as
6 to what was going on at the time that legislation was
7 enacted. So it was right after the Ceridian case was
8 decided, right, which essentially held that dividends that
9 were previously allowed at 100 percent for insurance
10 companies; and again, it was because the insurance
11 companies were based in California. So there were some
12 forward commerce clause issues in there, right. It was
13 held to be unconstitutional.

14 And in response, of course, right, there's a lot
15 of chaos with respect to those taxpayers that had taken a
16 dividends received deductions, those taxpayers that didn't
17 take a dividends received deduction. So legislation was
18 enacted that essentially said everybody gets 80 percent,
19 okay. But when we think about everybody having 80
20 percent, right, we have to think about it against the
21 backdrop of who was taking what and when, right. So we
22 had -- I'll call them A and B. We'll keep this as simple
23 as I possibly can.

24 And I promise I'm going to talk very slow because
25 I'm -- I tend not to.

1 So we'll talk about taxpayer group A. So
2 taxpayer group A, we'll say are those folks that
3 originally had taken 100 percent dividends received
4 deduction. The legislative history very clearly also
5 states that those folks, right, that the FTB had
6 disallowed expenses under 24425 -- sorry. And sort of,
7 again, so very clearly says that. And it says, listen,
8 we've got to fix it for those folks because now they're
9 going to have an 80 percent DRD, and they're going to be
10 up against the folks in the past, right, that had -- not
11 had to deal with 24425 because they took no dividends in
12 the first place, right.

13 So I think the legislature very clearly felt --
14 and -- and the language is pretty clear that they were
15 there for the folks in -- in Column A, right, again to
16 make them -- put them on the same playing field that the
17 folks in Column B were in. And that we should, therefore,
18 draw no inference post, right, because there was nothing
19 to be cured post that point because it was very clear
20 based on the authorities that would have existed at the
21 time that a partial DRD would have been includable in the
22 measure of tax. And then additionally, of course, right,
23 24425 was further amended adding subsection (b), right,
24 that dealt specifically with insurance companies. So I
25 think the legislature was also hesitant to make additional

1 statements with respect to 24425(a) in that industry as
2 well.

3 So, thank you.

4 JUDGE GAST: Thank you for that.

5 And then real quickly for the Franchise Tax
6 Board, going to the allocable to one or more classes of
7 income. In Great Western, the subsidiary was taxed on its
8 income out of which the dividends were paid. So how is
9 that -- how does that support your theory that the
10 expenses here should be disallowed? Because, in that
11 case, the subsidiary was taxed. In this case it wasn't,
12 and you're saying the subsidiary needs to be taxed?

13 MR. BECK: I'm saying the subsidiaries need to
14 be --

15 JUDGE GAST: Yeah, 'cause you're saying the
16 insurance subsidiaries exempt on the -- on the income
17 under the gross premiums tax. But here in Great Western
18 it was taxed, but the expenses were denied at the parent
19 still. Is there a distinguishing thing to that or --

20 MR. BECK: So for -- it's a little -- it's a
21 little bit un -- unclear because I -- I think the question
22 is whether or not it's an allocation to a class of income.
23 And you're looking at what is the expense, and then what
24 is the class of income its being allocated to. And so
25 based on the evidence, we're saying the expense is most

1 likely allocated to the class of income of the insurance
2 subsidiaries.

3 Now, that income is not included in the measure
4 of tax, and if -- if the income was included in the
5 measure of tax in Great Western, then that -- that just --
6 I mean, it's even more -- for Great Western, they looked
7 at the dividends -- the dividends, not the income of the
8 operating -- of the subsidiaries. So I guess one way to
9 distinguish them is that the -- that's looking at the
10 dividend, right, and it doesn't matter what -- like the
11 case in Great Western say, when you're just looking at the
12 dividend, it doesn't matter whether or not it was taxed or
13 not by the subsidiary by the company issuing the dividend.

14 JUDGE GAST: Okay. Thank you. I have no further
15 questions.

16 JUDGE LE: Thank you, everyone.

17 If there's anything else, I think that will
18 conclude our hearing.

19 Thank you, everyone, for come in today.

20 This case is submitted on February 12th, 2026.
21 The judges will meet and decide this case later on, and we
22 will send you a written opinion of our decision within
23 100 days.

24 Today's hearing in the Appeal of Liberty Mutual
25 Group, Inc., is now concluded, and we are off the record.

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(Proceedings concluded at 2:42 p.m.)

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HEARING REPORTER'S CERTIFICATE

I, Ernalyne 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 16th day of March, 2026.

ERNALYN M. ALONZO
HEARING REPORTER