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# State Tax Return

## California Appellate Court Finds Return of Principal on Short-Term Investments Is "Gross Receipts," But Excludes From the Taxpayer's Sales Factor

Kristi L. Stathopoulos
Atlanta
(404) 581-8512

Here we go again…. *Toys "R" Us, Inc. v. Franchise Tax Board*, 41 Cal. Rptr. 3d 285 (April 5, 2006), *opinion modified on denial of rehearing,* 2006 WL 1174136 (May 4, 2006), is the fourth in a line of California appellate court cases addressing the issue of whether the return of principal from short-term investments should be included in the sales factor for California apportionment purposes.

Although the courts have used slightly different reasoning, the effect has been the same for each of the taxpayers involved in these cases.[1] In the meantime, the California Supreme Court has granted a petition to review one of these cases, *General Motors Corp. v. Franchise Tax Board*, 16 Cal. Rptr. 3d 41.[2]

In *Toys "R" Us*, the California Court of Appeals, Third District, held that, although return of principal on short-term investments fell within the definition of "gross receipts," the inclusion of such receipts in the taxpayer's sales factor unfairly represented its business activity in the state. Thus, the Court allowed the Franchise Tax Board ("FTB") to invoke the equitable apportionment statute to exclude the principal from the sales factor.

Toys "R" Us ("Toys"), a California taxpayer, maintained a treasury department in New Jersey where Toys managed its short-term financial investment portfolio. Because investment in short-term financial instruments were usual, ordinary, and recurring transactions for Toys, it reported the income earned from such investments as business income on its California returns. On its initial returns, however, it excluded from the sales factor the return of principal received on such transactions, which would have been sourced outside of California.

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[1] In both *Limited Stores, Inc. v. Franchise Tax Board*, 2005 WL 1785249 (Cal. Dist. 1 Div. 5 Ct. App. July 28, 2005), and *General Motors Corp. v. Franchise Tax Board*, 16 Cal. Rptr. 3d 41 (Cal. Dist. 2 Div. 2 Ct. App. June 30, 2004), the courts held that a return of principal from securities transactions was not gross receipts because it did not arise out of sales transactions and, thus, declined to rule on the issue of equitable apportionment. In *Microsoft Corp. v. Franchise Tax Board*, 2005 WL 459697 (Cal. Dist. 1 Div. 3 Ct. App. Feb. 28, 2005), the court held that the Franchise Tax Board was entitled to exclude return of principal from the sales factor using equitable apportionment, declining to rule on whether such receipts were, in fact, gross receipts. However, the court indicated, in *dicta*, that returned principal should be systematically excluded from gross receipts.

[2] Cal. Dist. 2 Ct. App. June 30, 2004.

In July 2001, Toys filed a complaint for refund of taxes for the 1991-1994 tax years on the basis that all gross receipts received by Toys from the sale of short-term financial instruments must be included in the sales factor under CAL. REV. & TAX. CODE §§ 25120(e) and 25134.[3]

## Trial Court's Opinion

The trial court ruled in favor of the FTB. Under the court's reasoning, "sales" are a derivative of "gross receipts"; if no sale occurred, no gross receipts were produced. The court concluded that because Toys did not sell anything when it invested its spare cash, no gross receipts could have been generated by the return of principal.

In addition, the trial court found that Toy's construction of the sales factor does not reflect economic reality, is at odds with the goal of UDITPA, and could produce unreasonable or absurd results. Thus, the court concluded that the inclusion of principal would not fairly represent the extent of the corporation's business in the state.

After the trial court entered judgment, Toys filed a timely notice of appeal.

## Court of Appeals Decision

### *Definition of "Gross Receipts" Includes Return of Principal from Short-Term Investments*

Toys and the FTB fundamentally disagreed on whether a return of principal on short-term investments should be included in the sales factor denominator. Section 25134 provides that "[t]he sales factor is a fraction, the numerator of which is the total sales of the taxpayer in this state during the income year, and the denominator of which is the total sales of the taxpayer everywhere during the income year."

Section 25120(e) defines the term "sales" as meaning "all gross receipts of the taxpayer not allocated [as nonbusiness income]." In addition, California provides by regulation that, for purposes of the sales factor, "sales" means "all gross receipts derived by the taxpayer from transactions and activity in the regular course of such trade or business."[4]

Based on these definitions, Toys asserted that the plain language mandates that the term "all gross receipts" includes both the interest and the principal received on the sale of short-term investments. In contrast, the FTB contended that, in the case of investment transactions, only the interest earned on the transaction should be deemed a receipt.

The Court of Appeals agreed with the Taxpayer on the issue, holding that "[t]he term 'gross receipts' does not appear ambiguous; it means the total receipts taken in by a

[3] All further statutory references are to the California Revenue and Taxation Code unless otherwise indicated.

[4] CAL. CODE REGS. tit. 18, § 25134(a)(1).

corporation" and "necessarily includes the full amount realized on the redemption or sale of short-term securities."[5]

***Because Inclusion of Principal in the Sales Factor Would Unfairly Represent Toys's Business Activity, Equitable Apportionment is Proper***

The FTB made an alternative argument that the inclusion of return of principal from short-term investments in the sales factor does not clearly represent Toys's activity in California, and, hence, the FTB was entitled to invoke equitable apportionment.

Both parties argued that the other had the burden of proving whether the use of equitable apportionment was proper. However, the Court concluded that the burden rested with Toys because a taxpayer generally bears the burden of proof in a refund case and because the taxpayer possesses all material facts relevant to the inquiry.

California's equitable apportionment statute, § 25137, permits the FTB to utilize alternative apportionment methodologies "[i]f the allocation and apportionment provisions of this act do not fairly represent the extent of the taxpayer's business activity in this state." At trial, the FTB introduced an expert witness who testified that the inclusion of return of principal would result in an unrealistically low sales factor that would not fairly represent the taxpayer's business activities in the state.

The taxpayer, however, offered no evidence at trial to challenge or contradict the expert's calculations. Instead, Toys offered two theories in support of its position that the use of equitable apportionment was improper. First, Toys argued that the FTB's position and expert analysis rely solely on impermissible "separate accounting" within Toys's unitary business; thus, the FTB could not establish that the standard apportionment formula does not fairly represent the extent of Toys's California business activity. Second, it argued that § 25137 relief is unavailable because Cal. Code Regs. tit. 18, § 25137(a) limits such relief to "unique and nonrecurring" circumstances, whereas Toys's treasury function was usual, ordinary, and recurring.

The Court of Appeal rejected Toys's first argument, stating that, as a term of art, separate accounting in the tax context does not necessarily occur whenever a component of a unitary business is discretely analyzed. The Court noted that Toys's position would operate as a complete bar to anyone challenging any portion of a unitary business in order to ascertain whether the apportionment factor reflects true activity within a state.

The Court also refused to adopt Toys's interpretation of the equitable apportionment statute or the corresponding regulation. Section 25137 allows deviation from the allocation formula when the formula fails to "fairly represent the extent of the taxpayer's business activity." The regulation limits § 25137 to limited and specific cases, which will *ordinarily* be unique and non-recurring, but the Court found that the regulation does not limit § 25137 *only* to unique and non-recurring situations.

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[5] *Toys "R" Us*, 41 Cal. Rptr. 3d 285, at 294.

Thus, the Court of Appeals held that "the inclusion of the return of principal from short-term investments in the sales factor distorts the apportionment formula, preventing the formula under section 25120 from accurately reflecting Toys's business activity in California. Application of section 25137 was held to be appropriate to mandate inclusion of only the interest earned by short-term investments in the sales factor."[6]

**Where Do We Go From Here?**

As stated above, the California Supreme Court has granted a petition to review the decision in *General Motors*, which was also favorable to the FTB, although on the grounds that return of principal does not arise out of a sales transaction and, thus, is not a gross receipt. If the California Supreme Court agrees with this narrow definition of gross receipt, the issue will be resolved, much to the chagrin of California corporate taxpayers. If, however, the Court takes a more traditional view of what constitutes a gross receipt, taxpayers will still have to contend with the equitable apportionment issue.

Although the Third District Court of Appeals held that equitable apportionment adjustments are not limited to unique and non-recurring situations, if the statute is consistently invoked to apply to every taxpayer that has receipts from short-term investments, deviation from the standard apportionment formula will become the rule. Is this what the California Legislature intended? Furthermore, the California Legislature presumably understood the language it selected when drafting §§ 25134 and 25120 and has not since changed that language, despite the longstanding controversy. If the California Legislature wants the term "gross receipts" to denote anything other than *gross* receipts, perhaps it should change the statute.■

[6] *Toys "R" Us*, 41 Cal. Rptr. 3d 285, at 298.

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