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The California Supreme Court Addresses UDITPA "Gross Receipts" and Alternative Apportionment in *Microsoft* and *General Motors*

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On August 17, 2006, the California Supreme Court issued two eagerly-anticipated decisions in companion cases (*Microsoft*[1] and *General Motors*[2]) regarding the proper application of California's Uniform Division of Income for Tax Purposes Act ("UDITPA") sales factor provisions to determine the amount of receipts from certain treasury department activities. In *Microsoft*, the lead decision, the Court addressed the issue of whether the *redemption* of marketable securities generates "gross receipts" includible in the sales factor. In *General Motors*, the Court addressed the issue of how repurchase agreements should be treated in calculating the sales factor.[3]

Both cases involved Revenue and Taxation Code Section 25137,[4] the UDITPA provision for varying from the standard apportionment and allocation rules when the application of such rules does not fairly represent the extent of a taxpayer's business activity in California. This article discusses both cases, as well as developments in the California Legislature and within the Franchise Tax Board ("FTB") since the Court's decisions.

Gross Receipts Analysis

In *Microsoft*, the Court addressed the issue of whether the redemption of marketable securities held to maturity generated gross receipts includible in the sales factor. The analysis was centered on various statutory and regulatory definitions. California

[1] *Microsoft Corporation v. Franch. Tax Bd.*, 139 P.3d 1169 (Cal. 2006).

[2] *General Motors Corporation v. Franch. Tax Bd.*, 139 P.3d 1183 (Cal. 2006).

[3] Another issue in *General Motors* related to California's research tax credit was whether the credit goes only to the member performing the research or whether it may be spread among all members of the unitary group. The Court held that when research is performed by one member of a unitary group of taxpayers, only the corporation that performed the research is entitled to the credit.

[4] Section 25137 corresponds to the UDITPA Model Act Section 18. It provides: "If the allocation and apportionment provisions of this act do not fairly represent the extent of the taxpayer's business activity in this state, the taxpayer may petition for or the Franchise Tax Board may require, in respect to all or any part of the taxpayer's business activity, if reasonable: (a) Separate accounting; (b) The exclusion of any one or more of the factors; (c) The inclusion of one or more additional factors which will fairly represent the taxpayer's business activity in this state; or (d) The employment of any other method to effectuate an equitable allocation and apportionment of the taxpayer's income."

Revenue & Taxation Code § 25120(e) defines the term "sales" to mean "all gross receipts of the taxpayer not allocated [as nonbusiness income]." California regulation provide 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."[5] The term "gross receipts" is not defined.

On audit, the FTB allowed the inclusion of securities *sales* as gross receipts, but disallowed the "return of capital" for securities *redemptions* as gross receipts. For securities held to maturity, the FTB counted as gross receipts only the price differential between the redemption price and the purchase price.

In determining the meaning of "gross receipts," the Court first noted that the term "gross" implies the whole amount received, not just the amount received in excess of the purchase price, and that "[t]o only consider the net price difference as 'gross receipts' is an awkward fit with the statutory language, at best." Nevertheless, the Court considered the language of section 25120 "not unambiguous" and, for interpretive aids, turned to the legislative history of UDITPA, agency interpretation of section 25120, and the "economic reality" of the taxed transaction. Based on its analysis of legislative history, agency interpretation, and the economic reality of the transaction at issue, the Court agreed with Microsoft and held that "gross receipts" include the entire amount received upon redemption of a marketable security.

Regarding the economic reality of the transaction, the Court focused on the similarity between a sale and a redemption of a marketable security from the perspective of the taxpayer. In both circumstances (*e.g.*, the sale of a security one day before maturity and the redemption upon maturity), the investor relinquishes the identical bundle of rights that go with the security. The difference between these transactions exists only with respect to the recipient: in one case, a third party acquires the bundle of rights that the investor had; in the other case, because the recipient is the issuer of the security, the security is retired. From a tax perspective, the Court noted that "we are concerned only with the economic activity of the taxpayer/investor."

In *General Motors*, the Court was faced with a different treasury activity (*i.e.*, repurchase agreements, or "repos"). The Court reasoned that repos differ from other marketable securities in that repos more closely resemble loans because the sale price is fixed by the initial cost, rather than market fluctuations in the value of the securities. The Court held that because the repayment of a loan is never considered a receipt, only the interest received from such investments falls within the definition of "gross receipts."

Section 25137- Variation from Standard Apportionment

Although the *Microsoft* Court ruled in the taxpayer's favor on the gross receipts issue, the Court affirmed the Court of Appeal's holding in favor of the FTB that the exclusion of the "returned capital" portion of the redemptions was authorized under Revenue and Taxation Code Section 25137. In doing so, the Court found that the party invoking section 25137, the FTB in this case, has the burden of proving by "clear and convincing

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

evidence" both that 1) the approximation provided by the standard formula is not a fair representation of the extent of the taxpayer's California business activity, and 2) the proposed alternative is reasonable.

Regarding the burden of proof that the standard formula is not a fair representation of the extent of the taxpayer's California business activity, the Court held that mixing the gross receipts from Microsoft's short-term investments with the gross receipts from its other business activity "seriously distorts the standard formula's attribution of income to each state." Among other things, the Court found persuasive a State Board of Equalization ("SBE") decision where the SBE described the sales factor as intended to "reflect the markets for the taxpayer's goods or services" and asked whether the inclusion of all investment receipts would serve that function.[6]

Focusing on the situation when treasury activities give rise to relatively low-margin sales compared to nontreasury activities, the Court found that such a situation "presents a problem for the UDITPA." The Court concluded that "[t]he UDITPA's sales factor contains an implicit assumption that a corporation's margins will not vary inordinately from state to state." In applying this kind of analysis to Microsoft, the Court noted that the treasury activities of Microsoft "generated minimal income (just under 2 percent of Microsoft's business income for 1991) but enormous receipts (approximately 73 percent of gross receipts for 1991.)" The Court held that the distortion shown "is of both a type and size properly addressed through the invocation of section 25137."

As stated above, the party invoking section 25137 must not only prove distortion; the proffered alternative must also be reasonable. Here, the Court had little to say, other than that because the net receipts are so small in comparison with Microsoft's nontreasury income and receipts, the inclusion of net receipts is reasonable. The Court went on to hold that "[i]f the Board's proposal is reasonable, we are not empowered to substitute our own formula." The Court cautioned that although the FTB's formula was reasonable in this case, in other cases it may not be. The Court warned that if treasury operations constitute a substantial portion of a taxpayer's income, mixing net receipts from those transactions with gross receipts from all other transactions will unfairly minimize the contribution of the treasury function and unfairly inflate California tax liability.

In *General Motors*, the FTB reserved, in a stipulation prior to entry of judgment, the right to argue that any gross securities proceeds included in the sales factor produced distortion and should be excluded under section 25137. Because General Motors had redemptions of securities that should have been treated as gross receipts, the Court remanded for further proceedings to allow the FTB to make its Section 25137 case in accordance with the principles set out in *Microsoft*.

Despite its victories in *Microsoft* and *General Motors*, the FTB filed petitions for rehearing in both cases with the California Supreme Court on a number of issues it has with the decisions. Among the issues raised, the FTB takes exception to the Court's

[6] *Pacific Telephone and Telegraph Company*, 78-SBE-028 (May 4, 1978).

holding that the FTB, when invoking section 25137, has the burden of proof by clear and convincing evidence. As of the publication of this article, the Court has not acted on the petitions for rehearing.

Franchise Tax Board Notice 2006-3

On September 28, 2006, the FTB published Notice 2006-3, explaining the implications of the *Microsoft* decision for previously issued FTB Notice 2004-5. Notice 2004-5 explains that a taxpayer seeking a variation from the standard apportionment and allocation rules under section 25137 must first petition for an alternative. The Notice further provides that if an audit examination determines that a taxpayer has filed its original return in a manner inconsistent with the standard apportionment and allocation rules without prior approval for the position, such return is erroneous and may be subject to the accuracy related penalty.

Notice 2004-5 provides an exhaustive list of the types of authority that will constitute prior approval to file an original return in a manner inconsistent with the standard apportionment and allocation rules. Prior approval will be deemed to have been provided only if the treatment 1) is an RTC § 25137 variation permitted in an audit manual that was operative during the taxable year, or which is currently operative, and the taxpayer's facts are substantially the same as those described in the manual; 2) is the same variant specifically permitted under authority of § 25137 in a published opinion of the Board of Equalization, a California Court of Appeal, or the California Supreme Court, and the taxpayer's facts are substantially the same as those described in those opinions; 3) has been approved in writing in a prior year petition under § 25137 that specifically provides that the variation also applies to the year in question; or 4) has been approved in a closing agreement for an earlier year that by its terms also applies to the taxable year of the return.

The FTB issued Notice 2006-3 to address the *Microsoft* decision, and particularly the Court's holding (contrary to the FTB's position) that the redemption of marketable securities generates gross receipts includible in the sales factor for under the standard apportionment rules. This Notice provides that, for purposes of applying Notice 2004-5, a taxpayer who excludes the amount realized on the redemption of marketable securities as part of its treasury function from the sales factor, and includes only the interest income and net gains from such securities, will not be subject to the accuracy-related penalty under the authority of the *Microsoft* decision and the *Appeal of Pacific Telephone & Telegraph*. The Notice further provides that the determination of whether such receipts should be excluded will remain subject to audit and adjustment.

Proposed Legislation

On February 22, 2005, over a year before the California Supreme Court issued its opinions, California Assembly Member Dario Frommer introduced Assembly Bill No. 1037 to amend the definition of "gross receipts" in § 25120. The amendment provided that "gross receipts" include "total sales arising from a treasury function," which latter term is defined as the net gain, including interest and dividends, realized by taxpayers from transactions undertaken as part of a treasury function. The bill was amended six

times in the course of the 2005-2006 Session of the California Legislature, but ultimately failed to pass before the expiration of the legislative session on August 31, 2006.

Implications for Taxpayers

Any California "legislative fix" to address the impact of the treasury function of a company on the determination of the sales factor for apportionment purposes, will have to be carefully worded in order to be truly viewed as a "fix." If a statutory amendment involves rote inclusion of only net gain and interest from treasury function receipts, the type of "systematic oversights and undersights" that concerned the *Microsoft* Court will still arise any time a company's treasury functions are not qualitatively different from its main business.

We can expect ever-increasing litigation in California under section 25137 and in other states under similar provisions. As the businesses of taxpayers become more complicated and diverse, the likelihood that the standard apportionment formulas in various states will fairly represent the activity of specific taxpayers arguably decreases. The *Microsoft* Court explicitly rejected the taxpayer's contention that section 25137 applies only to unique, nonrecurring situations in stating, "the statutory touchstone remains an inquiry into whether the formula 'fairly represents' a unitary business's activities in a given state, and when it does not, the relief provision may apply."

Strong arguments exist that state law provisions (UDITPA § 18) allowing variations from a statutorily-mandated apportionment formula should be invoked only to avoid an unconstitutional result in applying the standard formula, *i.e.*, distortion of a constitutional significance. However, the interpretation of states and state courts is a broader authority for alternative apportionment methods.

As states become more aggressive in seeking to impose variation from the standard apportionment formula, taxpayers should as well. This means holding taxing jurisdictions to the burden of proof required in seeking a variation and in proving the reasonableness of the alternative method. To avoid being whip-sawed, taxpayers should actively invoke such relief provisions where the facts warrant such relief. Historically, taxpayers may have been reluctant to challenge the standard apportionment formula considering the high burden of proving distortion of a constitutional significance, i.e., "clear and cogent evidence that the income attributed to the state is in fact out of all appropriate proportion to the business transacted in the state, or has led to a grossly distorted result."[7] However, as the Court held in *Microsoft*, the burden of proof to prevail on UDITPA § 18 relief, at least in California, is clear and convincing evidence that the approximation provided by the standard formula is not a "fair representation" of the extent of the taxpayer's business activity in the state and that the proffered alternative is "reasonable."■

[7] See *Moorman Manufacturing Co. v. Bair*, 437 U.S. 267 (1978).

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