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Sales Factor Gross Receipts Cases Addressed by the California Supreme Court

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After years of litigation and speculation, the California Supreme Court issued its decisions in *Microsoft Corp. v. Franchise Tax Board*, 139 P.3d 1169 (Cal. 2006) ("*Microsoft*") and *General Motors Corp. v. Franchise Tax Board*, 139 P.3d 1183 (Cal. 2006) ("*General Motors*"). Both cases presented the Revenue and Taxation Code section ("section") 25120 "gross receipts" issue and the section 25137 "distortion" issue. The decisions will unquestionably have varied and widespread effects on many taxpayers doing business in California.

The court treated *Microsoft* as the lead opinion on the gross receipts and distortion issues. The court framed the two issues as follows: (1) whether the redemption of marketable securities at maturity generates "gross receipts" (or, alternatively, the net price difference) includible in the sales factor; and (2) if so, whether the FTB met its burden of showing section 25137 should be applied. In *General Motors*, the court addressed another gross receipts issue not present in *Microsoft*: how repurchase agreements ("repos") are to be treated for sales factor purposes.

In short, the court ruled in *Microsoft* that: (1) the redemption of marketable securities at maturity does generate gross receipts for sales factor purposes; and (2) the FTB did meet its burden under section 25137, and an alternative apportionment formula should be used. In *General Motors*, the court ruled repos have the characteristics of loans and therefore only the interest received is a gross receipt for purposes of section 25120.

The Court's Section 25120 "Gross Receipts" Analysis

Microsoft and General Motors separately argued the entire gross proceeds from certain treasury function transactions must be included in their respective sales factor as "gross receipts" under section 25120. Microsoft's transactions mainly included marketable securities held to maturity, while General Motors' transactions included both marketable securities held to maturity and repurchase agreements. The Supreme Court concluded in both cases the entire gross receipts from marketable securities held to maturity are to be included in the sales factor, but that only interest from repurchase agreements is to be included in the sales factor.

Microsoft addressed the issue in the context of marketable securities. First, the court in *Microsoft* stated that the meaning of "gross receipts" in section 25120 "more naturally includes the entire redemption price of marketable securities." *Microsoft,* 139 P.3d at 1174. The court stated that inclusion of only the net difference as gross receipts "is an awkward fit with the statutory language, at best." *Id*. Second, the court stated the legislative history behind section 25120 supports inclusion of marketable securities held to maturity as gross receipts. Section 25120 is part of the Uniform Division of Income for Tax Purposes Act ("UDITPA"), which a number of states, including California, have adopted to determine multistate taxpayers' apportioned income. The court noted that an early version of the UDITPA defined "sales" as "all income of the taxpayer" not otherwise allocated, but this provision was amended to define "sales" instead as "all gross receipts of the taxpayer" not otherwise allocated. *Id*. Third, the Court stated that inclusion of the entire gross proceeds is also supported by the State Board of Equalization's interpretation of gross receipts to include the full amount of any redemptions ("albeit in a more limited fashion"). *Id*. at 1175. Fourth, the Court looked

to the "economic reality" of the taxed transaction and concluded "the full redemption price, like the full sale price, must be treated as gross receipts" under section 25120. *Id*. Accordingly, the court in *Microsoft* held the entire redemption price of marketable securities is included within the statutory meaning of "gross receipts." *Id*. at 1174.

General Motors addressed the issue in the context of repos. The court in *General Motors* concluded that although repos are truly "hybrids" that blend characteristics of both a sale of securities and a secured loan, for gross receipts purposes, a repo has the characteristics of a loan. Thus, the court held only the interest received on a repo is a gross receipt for purposes of the sales factor. *General Motors,* 139 P.3d at 1192.

The Court's Section 25137 "Distortion" Analysis

Having concluded in *Microsoft* the full redemption price constitutes gross receipts, the court turned to the application of the alternative apportionment provisions of section 25137. Section 25137 provides, in pertinent part, that if the allocation and apportionment provisions of the UDITPA (*i.e.,* sections 25120 through 25139) do not "fairly represent the extent of the taxpayer's business activity in this state," the taxpayer may petition for or the FTB may require, "in respect to all or any part of the taxpayer's business activity, if reasonable," separate accounting, the inclusion or exclusion of one or more factors, or "the employment of any other method to effectuate an equitable allocation and apportionment of the taxpayer's income."

Before addressing whether the alternative apportionment provisions of section 25137 applied to the facts of the case, the court addressed the issue of which party bears the burden of proof under section 25137. Although FTB was the party seeking application of section 25137, it had nonetheless argued the taxpayer bears the burden of proof. The court found that FTB, as the party invoking section 25137, bears the burden of proving by clear and convincing evidence that: (1) the approximation provided by the standard formula is not a fair representation; and (2) its proposed alternative is reasonable. *Microsoft,* 139 P.3d at 1177. The court concluded that FTB met its burden of proof "in this instance." *Id*.

Section 25137 permits deviation from the standard allocation and apportionment provisions of UDITPA only where they "do not fairly represent the extent of the taxpayer's business activity in this state." The court in *Microsoft* considered the conditions under which the inclusion of a particular treasury activity in the standard apportionment formula would produce distortion sufficient to invoke section 25137. The result of the court's analysis is both a qualitative and quantitative analysis of the business activity in question. *Id.*at 1178.

As part of the qualitative analysis, the Court drew a distinction between the business activity in question, *i.e.,* Microsoft's treasury department transactions, and the core business of Microsoft in order to determine whether the activity in question is a fundamental part of, or incidental to, the primary business. *Id.*

For business activities which are a part of the taxpayer's core business, the Court cited with approval the quantitative analysis in the State Board of Equalization's (SBE) decision in *Appeal of Merrill, Lynch, Pierce, Fenner & Smith, Inc.,* 89-SBE-017 (SBE June 2, 1989) ("*Merrill Lynch*"). In *Merrill Lynch*, the FTB objected to inclusion of full gross receipts for securities bought as a principal/underwriter, but the SBE rejected that argument. In rejecting the FTB's arguments, the SBE compared the standard apportionment formula with the proposed alternate formula. The SBE determined that Merrill Lynch's sale of securities on its own account was not qualitatively different from its main business, and the resulting quantitative difference between the standard formula and the Board's proposed formula was on the order of 23 to 36 percent. No quantitative distortion was found to exist in *Merrill Lynch*.

For business activities which are not a part of the taxpayer's core business, the Court cited with approval the quantitative analysis in the SBE's decision in *Appeals of Pacific Telephone & Telegraph Co.,* 78-SBE-027 (SBE May 4, 1978) ("*PacTel*"). In *PacTel*, the taxpayer argued it was entitled to include the full gross receipts from its treasury department's investments in the sales factor. The investments produced less than 2 percent of the company's business income, but 34 percent of its gross receipts. The SBE described the sales factor as intended to "reflect the markets for the taxpayer's goods or services" and asked whether inclusion of all investment receipts would serve that function. The SBE answered in the negative, holding the "inclusion of this enormous volume of investment receipts substantially overloads the sales factor in favor of New York, and thereby inadequately reflects the contributions made by all the other states, including California, which supply

the markets for the . . . services provided by [the taxpayer]." Quantitatively, the SBE stated that since the treasury department's gross receipts constituted approximately 34 percent of total gross receipts, inclusion of such receipts would result in approximately one third of the taxpayer's total sales, and therefore at least 11% of the taxpayer's total business activities being apportioned to New York where the treasury function was located. The SBE stated, "we are unable to accept, even for a moment, the notion that more than 11 percent of [the taxpayer's] entire unitary business activities should be attributed to any single state solely because it is the center of working capital investment activities that are clearly only an incidental part of one of America's largest, and most widespread, businesses."

The court in *Microsoft* also focused upon treasury department distortion arising from differing margins (*i.e.,* differences between cost and sale price) that may be several orders of magnitude different than those for other commodities of the business. 139 P.3d at 1179. The court stated that modern treasury departments whose operations are qualitatively different from the rest of a corporation's business and whose typical margins may be quantitatively several orders of magnitude different from the rest of a corporation's business pose a problem for the apportionment formula. *Id*. The court underscored the qualitative recognition that the different nature of short-term investments means that mixing short-term receipts with gross receipts from other types of business activities involves an "apples-to-oranges" comparison that may require correction under section 25137. *Id*. at 1180.

Applying section 25137 to the facts in *Microsoft*, the court concluded mixing the gross receipts from Microsoft's short-term investments with the gross receipts from its other "core" business activity "seriously distorts the standard formula's attribution of income to each state." *Id.* at 1181. The *Microsoft* Court held:

> These transactions 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). Their inclusion in the standard formula would result in reducing roughly by half the estimated income attributed to California, and likely every state other than Washington, depending on the property and payroll factors. The distortion the Board has shown here is of both a type and size properly addressed through invocation of section 25137; application of the standard formula does not fairly represent the extent of Microsoft's business in California.

Id.

Finally, the court in *Microsoft* observed that any proposed alternative solution under section 25137 must be reasonable. The court held that "[b]ecause the net receipts are so small in comparison with Microsoft's nontreasury income and receipts," the inclusion of net receipts instead of gross receipts was reasonable. *Id.*The court cautioned, however, that "mixing net receipts for a particular set of out-of-state transactions with gross receipts for other transactions . . . minimizes the contribution of those out-of-state transactions," and in other cases this approach "may go too far in the opposite direction and fail the test of reasonableness." *Id.*

In *General Motors*, the court ordered the case be remanded to the lower courts to allow the FTB "to make its section 25137 case" in accordance with the principles set out in Microsoft. *General Motors*, 139 P.3d at 1193. *General Motors* was remanded shortly after the FTB's petitions for rehearing were denied by the Court, in both cases, in late October 2006.

Where Do We Go From Here?

Neither *Microsoft* nor *General Motors* is a clear victory for the parties or the many taxpayers waiting for the decisions. Both cases raise important issues that will likely affect many taxpayers doing business in California. The California Supreme Court has not publicly expressed an across-the-board approach that will determine the answer in every case. Depending on the particular facts and circumstances of the individual taxpayer, the resolution may vary significantly. Further litigation may ensue as a result of the court's section 25137 analysis and its application in particular cases.

A legislative fix could also be on the horizon for the gross receipts and distortion issues. The court welcomed the California Legislature "to follow [the] leads" of other states that have amended their sales factor statutes to expressly exclude investment returns of capital from the definition of gross receipts. *Microsoft,* 139 P.3d at 1182. Assembly Bill ("A.B.") 1037, which would have prospectively changed the treatment of investment returns of capital under the UDITPA, did not pass in the 2005-2006 California legislative session. *See* A.B. 1037, 2005-06 Leg., Reg. Sess (Cal. 2006). It is yet to

be determined whether a similar bill will be introduced in the next legislative session.