

FINAL STATEMENT OF REASONS
FOR ADOPTION OF CALIFORNIA CODE OF REGULATIONS,
TITLE 18, SECTION 25137(c)(1)(D)

The proposed regulations do not impose any mandate on local agencies or school districts.

The public Notice required by Section 11346.4 of the Government Code was mailed and published in the California Notice Register on June 29, 2007. The hearing was held, as noticed, on August 17, 2007, to consider the adoption of proposed regulation section 25137(c)(1)(D), which addresses the sales factor treatment of receipts derived from a taxpayer's "treasury function" activity. There were 24 attendees at the hearing and oral testimony was received from four individuals representing various interests. Written comments were received from seven different commentators during the comment period, which was extended to September 17, 2007, due to a request by an attendee at the hearing. A summary of and responses to the comments received was prepared and is included in the rulemaking file as Tab 10-C. The comments received did not require any changes to the regulation as originally noticed. Four oral comments were received at the hearing.

The regulation was presented to the Franchise Tax Board for its approval at its November 28, 2007, public meeting. The Board was provided with all of the comments received during the regulatory process as well as responses to the comments. The Board adopted the regulation by a vote of 3-0. A transcript of that public meeting is included in the rulemaking file as Tab 11.

The proposed regulation is intended to specify a general rule for the sales factor treatment of gross receipts generated by a taxpayer's treasury function. A treasury function involves the pooling, management, and investment of intangible assets for the purpose of satisfying the cash flow needs of the trade or business, such as providing liquidity for a taxpayer's business cycle. The amount to include in the sales factor from this activity has been the subject of numerous litigation cases. In 2006 the California Supreme Court addressed this issue in two cases: Microsoft Corporation v. Franchise Tax Board (2006) 39 Cal.4th 750, and General Motors Corporation v. Franchise Tax Board (2006) 39 Cal 4th 773. The Microsoft decision held that the proceeds from treasury activity, which includes interest income, net gains and the return of capital, constituted receipts for sales factor for purposes of Revenue and Taxation Code sections 25120 and 25134, but that such receipts should be removed from the sales factor under the authority of Revenue and Taxation Code section 25137 if the inclusion of the receipts results in the apportionment formula failing to fairly represent the taxpayer's activities in the state. General Motors took this analysis a step further and held that, while a treasury function activity can give rise to gross receipts includable in the sales factor, the amount of receipts to be included is subject to an analysis of the type of instrument invested in by the treasury department. General Motors held that the return of principal on the repayment of a loan did not constitute a receipt for sales factor purposes and specifically that "repurchase agreements" constituted loans. The General

Motors decision did not address what other investments might constitute loans. Because these cases were decided based on the facts and circumstances of each case, this has led to uncertainty for taxpayers and the Franchise Tax Board, as each taxpayer must determine whether their facts are similar enough to the case law to apply the Court's holdings to its particular circumstances. Taxpayers have requested a more uniform approach to this issue, which will provide certainty regarding the proper sales factor treatment for this activity.

The staff of the Franchise Tax Board held several interested parties meetings to discuss these two recent decisions by the California Supreme Court. Comments at those meetings supported the adoption of a regulation. The analysis by the California Supreme Court in Microsoft was based on the statute that authorizes this regulation, Revenue and Taxation Code section 25137,¹ and statements made by the Court in its decision support the use of a standardized approach.

In reaching its decision to regulate in this area, the staff of the Franchise Tax Board, in addition to the comments received through the interested parties process, relies upon (1) the two recent California Supreme Court cases cited above; (2) other litigation cases, including the court of appeal's decision in The Limited Stores, Inc., et al., v. Franchise Tax Board (1st District, 2007) 62 Cal Rptr. 3d 191 (The Limited), which applied the Court's Microsoft opinion and held in favor of the application of Revenue and Taxation Code section 25137 to remove treasury function gross receipts from the sales factor, as well as other decisions of the court of appeals vacated by the Supreme Court when it took up the Microsoft case; (3) cases before the Board of Equalization, both decided and pending, including Appeal of Pacific Telephone and Telegraph, 78-SBE-028 (Pacific Telephone), (4) other cases pending in the administrative process that have raised this issue; (5) existing model regulations promulgated by the Multistate Tax Commission; and (6) actions taken by other states to address this issue. All of these resources support the use of Revenue and Taxation Code section 25137 to regulate in this area to exclude receipts derived from a treasury function.

¹ Rev. & Tax. Code § 19503 is the general authority for the Franchise Tax Board to promulgate the proposed regulation, providing, in relevant part, that the FTB "shall prescribe all rules and regulations necessary for the enforcement of [the income and franchise tax laws]." The provision of law which the FTB is implementing and interpreting is Rev. & Tax. Code § 25137, which states in part:

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 . . . the employment of any other method to effectuate an equitable allocation and apportionment of the taxpayer's income.

In promulgating the proposed regulation, the FTB is properly exercising its mandate to interpret and apply Rev. & Tax. Code § 25137 through regulations, as it has done at least fourteen times before. The regulations previously promulgated by the FTB under Rev. & Tax. Code § 25137 include both industry-specific regulations, such as those applicable to the banking (Cal. Code Regs., tit. 18, § 25137-4.2) and motion picture industries (Cal. Code Regs., tit. 18, § 25137-8), and also generally applicable regulations, such as Cal. Code Regs., tit. 18, § 25137(c)(1)(A), which requires occasional sales producing substantial amounts of gross receipts to be thrown out of the sales factor. The proposed regulation falls into this latter category and, indeed, is closely akin to the aforementioned throw-out rule.

In addition, during the formal regulatory process, and in response to comments received from the public, the hearing officer undertook a study of pending cases in order to determine whether the facts held to be distortive by the Court in Microsoft were unusual or whether the facts were typical facts for taxpayers raising the treasury function issue. The results of this study are included in the rulemaking file as Tab 10-D.

Thirty-four cases were found that were developed in enough detail to compare them to the existing case law. These cases involved over fifty tax years. The cases revealed that the average treasury function case is quite similar to the prior cases where distortion has been found. On average, the treasury function produced 50% of the receipts in the sales factor and approximately 3% of the income in the cases examined. These amounts compare favorably with the facts of Microsoft as well as the facts of Pacific Telephone, cited approvingly by the Microsoft Court, and the facts of The Limited.

The study supports the regulation by confirming that the decision of the Court in Microsoft is factually applicable to most taxpayers who maintain a treasury function and, therefore, the removal of the gross receipts related to this function is a proper application of Revenue and Taxation Code section 25137.

In regards to the activities of other states, the hearing officer provided additional detail on this point in the responses to comments as well. The comment responses set forth that states with almost identical authority to Revenue and Taxation Code section 25137 have utilized a regulatory approach to address the treasury function issue. For instance, Haw. Rev. Stat. § 235-38 is identical to Revenue and Taxation Code section 25137 and Hawaii has promulgated a regulation to reduce treasury function receipts to net income.² Other states, including Idaho,³ New Mexico⁴ and Utah⁵ all provide for special treatment for treasury function receipts through the use of regulations promulgated under similar statutory provisions. These authorities all support the FTB's position that there is nothing improper about addressing this issue through a regulation.

Commentators opposed to the regulation expressed a belief that the regulation was improper because the regulation removes the receipts from the treasury function entirely rather than including the receipts at net income or through some other measure. These commentators argued that the removal of the receipts entirely was inconsistent with prior case law, all of which allowed the inclusion at net income, and therefore is improper and possibly unconstitutional.

The removal of the receipts in their entirety is supported by at least three reasons:

² Haw. Admin. Rules 18-235-38-03(f).

³ Idaho Admin. Rules 35.01.01.570.03

⁴ N.M. Admin. Code 3.5.19.11(A)(4)

⁵ Utah Admin. Rules R865-6F-8(10)(c)(iv)

1. The difference between inclusion at net income and the throw out of the receipts entirely is immaterial for most taxpayers because most taxpayers simply do not receive large amounts of income from the treasury function and its inclusion in the factor at net income is immaterial to the factor. This clearly was the case in Microsoft, where the receipts generated \$10.7 million and were added to a sales factor denominator of \$2.1 billion. (This would change the sales factor by approximately 3 hundreds of 1% and the overall formula even less.)

This is also borne out by the study of developed cases, where the analysis yielded an average of 3% of income being derived from the treasury function while the sales factor included all of the gross receipts (far greater than income) of the business. While it is true that the Microsoft Court expressed possible concerns, and the possibility of reaching a different conclusion, in situations where the income produced by treasury activity was more significant than its reflection in the sales factor (for instance 50% of the income and 5% of the sales factor), that fact pattern is simply not the typical treasury function fact pattern.

2. Compliance with throw out is easier for taxpayers. Comments were received during the regulatory process that the exclusion of receipts was easier and more cost effective for taxpayers than tracking the receipts by type of security, as would be required by the General Motors opinion, to determine what was or was not includible for a resulting immaterial inclusion of net income. This is especially true if the taxpayer is not currently tracking the receipts due to the removal of the receipts by the laws of its home state.⁶

3. The use of throw out is consistent with all of the other rules promulgated under regulation section 25137(c). All of this regulation section's provisions remedy unusual situations by excluding from the sales factor the receipts derived from these activities. For instance, regulation section 25137(c)(1)(A) excludes substantial, occasional sales from the sales factor. The result of this exclusion is that the income derived from these transactions is assigned based on the normal sales factor of the taxpayer, which reflects the market for its goods or services. The effect of the throw out is the same for the treasury function.

Furthermore, the preeminent legal scholar in the field of state taxation, Walter Hellerstein, has supported the use of throw out on this basis. In his treatise on State Taxation, Professor Hellerstein states:

A similar analysis applies to the sales factor. Receipts from intangible property are no more geographically determinate than the property from which they are derived. As in the case of intangible property, however, there are conventions for attributing intangible receipts to a particular jurisdiction. With respect to such receipts, the jurisdiction of choice is

⁶ At least fourteen other states entirely exclude from the sales factor the types of receipts generated by a treasury function.

typically the taxpayer's commercial domicile. However, as in the case of intangible property, this tends to produce arbitrary results, effectively assigning large amounts of intangible income to a single state, despite the plausible claims of other states to a share of such income based on the adoption of some other attribution rule. Accordingly, a rule that assigns intangible receipts on the basis of the factors derived from the taxpayer's other business activities may be the most appropriate way to deal with receipts from operationally connected intangible property.

There is an additional reason for employing a rule that assigns receipts from operationally connected intangible property on the basis of the factors derived from the taxpayer's other business activities. The assignment of receipts to a single state under the widely used commercial domicile rule may have a distorting effect beyond that which has already been identified. This is because there is no necessary correlation between the amount of receipts and the corresponding amount of income from certain types of intangible investments. For example, the purchase at a discount of a thirty-day \$1 million certificate of deposit at the beginning of each month and its sale or redemption at the end of the month would yield \$12 million in receipts during the course of a year whereas the purchase at a discount and subsequent sale or redemption of a one-year \$1 million certificate of deposit would yield only \$1 million. Yet the intangible interest income earned from these investments is likely to be quite similar and clearly will not vary by a factor of twelve.

State taxing authorities have viewed the effect of including the receipts in the apportionment formula (which generally increases the commercial domicile's apportionment percentage while reducing the apportionment percentage of other states in which the taxpayer does business) as distortive. They have sought to deal with the problem by including only the net income from temporary cash investments in the apportionment factors on the basis of the equitable apportionment provision of the corporate income tax statute. Litigation over this question has produced mixed results, and legislatures have sometimes intervened to address the problem. The adoption of a rule that assigns receipts from operationally connected intangible property on the basis of the factors derived from the taxpayer's other business activities rule for intangible receipts would largely eliminate the issue.

A copy of this portion of Professor Hellerstein's treatise (Hellerstein & Hellerstein: *State Taxation* (3rd Edition), Par. 9.15[3][a][ii]) is included as Tab 13.

Finally, it should be noted that if the taxpayer, or the department, believes that the general result provided for by this regulation does not fairly reflect the taxpayer's activities in a particular case, the option of invoking the relief provisions of Revenue and Taxation Code section 25137 in order to utilize an

alternative formula, other than the proposed regulation, still exists. The Board of Equalization has held this to be the case in Appeal of Fluor, 95-SBE-016 (December 12, 1995). However, through this regulatory process it was concluded that throw out of receipts arising from treasury activity is the best result in most cases. For most taxpayers the difference between throw out and net income inclusion will be immaterial and the proposed regulation assigns the receipts by the activities of the main line of business, which is the correct result.

ALTERNATIVES DETERMINED

The Franchise Tax Board has not received any proposed alternatives that would be more effective in carrying out the purpose of the proposed regulation or would be as effective and less burdensome to affected private persons or small businesses than the proposed regulation. In addition, the proposed regulation pertains to corporate taxpayers and therefore does not affect private individuals.