



STATE OF CALIFORNIA  
**Franchise Tax Board**

# Section 25137 Petition Hearing

Irina Iskander Krasavtseva, Tax Counsel IV, MTB

Delinda Tamagni, Assistant Chief Counsel, MTB

Legal Division

June 26, 2023



# Roadmap

---

- ❑ Legal Framework
- ❑ Taxpayer's Relevant Activities in California
- ❑ Factor Representation vs. Double Counting
- ❑ Conclusion



# Apportionment Formula: General

---

- ❑ Apportionment is a method of assigning income to various states where a taxpayer's business activities take place. It is NOT a method for determining income.
- ❑ Fair apportionment is about fair factor representation.

# Apportionment Formula: General

---

- ❑ States are permitted to tax “an apportionable share of the multistate business carried on in part in the taxing State.”
- ❑ “States [are given] wide latitude to fashion formulae designed to approximate the in-state portion of value produced by a corporation's truly multistate activity.”

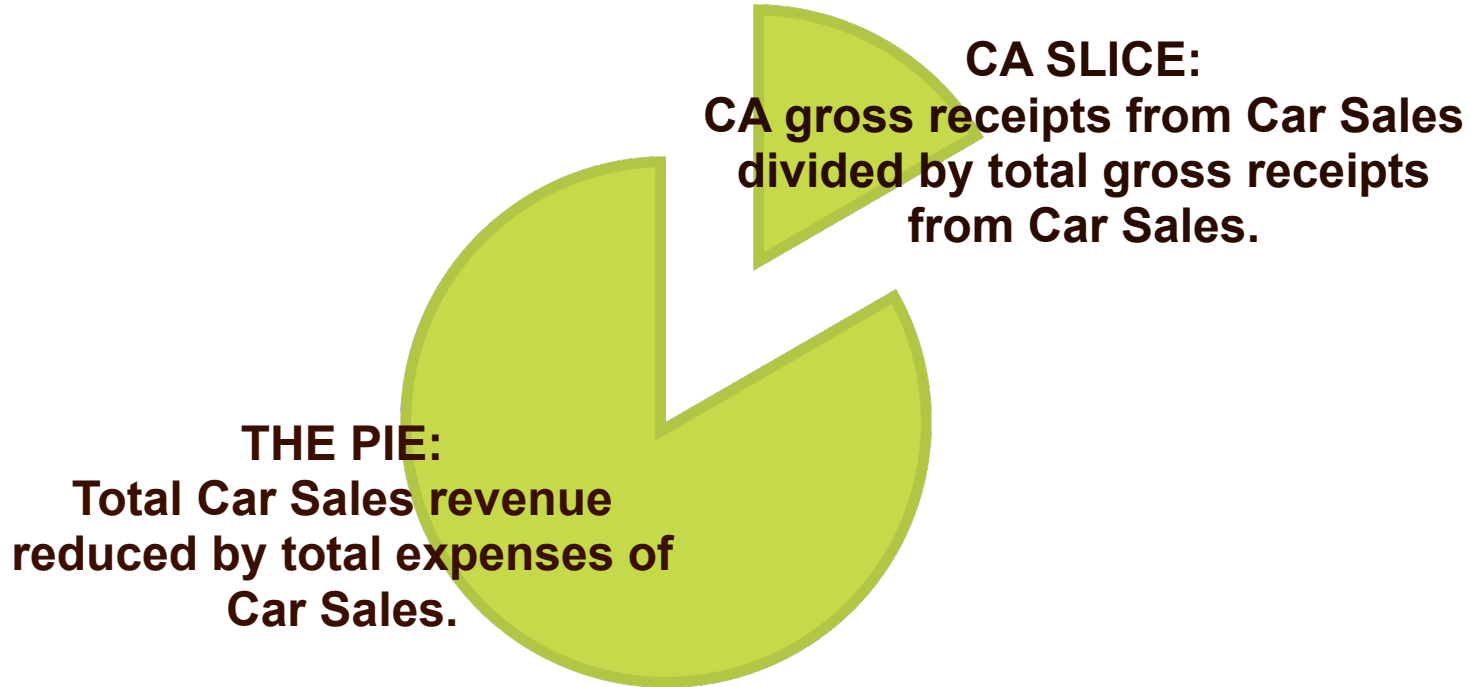
*Allied-Signal, Inc. v. Dir., Div. of Taxation, U.S. Supreme Court, 1992.*

# Standard Apportionment Formula: Single Sales Factor

$$\text{Sales Factor} = \frac{\text{CA gross receipts from regular trade or business activities}}{\text{U.S. gross receipts from regular trade or business activities}}$$

# Apportionable Income vs. Apportionment Formula: Example, Car Sales Only

---



# Section 25137

---

Allows for deviation from standard apportionment rules:

1. by either a taxpayer or the Franchise Tax Board, and
2. in situations where application of the standard rules ***does not fairly represent the extent of the taxpayer's business activity in this state.***

# Burden of Proof

---

The party invoking section 25137 has 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 v. Franchise Tax Board*, Supreme Court of California, 2006



# Unfair Representation: Examples

- ❑ “Operation of a large treasury department unrelated to a taxpayer's main business is a paradigmatic example of circumstances warranting invocation of section 25137.” (*Microsoft*, 2006.)
  - ❖ Treasury activity generated only 2% of the company’s total business income but about 73% of its total gross receipts.
- ❑ “[A] different but equally valid paradigm warranting invocation of section 25137 [involves]: sales activity that is not conducted for its own profit, and that has a substantially distortive effect on the standard apportionment formula....” (*General Mills II*, 2012.)
  - ❖ Hedging activity generated at most 2% of the company’s total business income but 8-30% of its total gross receipts.

# Facts: Distinct Business Transactions – Two “Legally Separate” & “Independent” Units

## INDUSTRIAL BUSINESS

### Wholesale Market

- ❑ MBUSA, LLC, (“MBUSA”) earns sales revenue from the sale of cars to unrelated Dealers.

## FINANCIAL SERVICES BUSINESS

### Finance & Securities Markets

- ❑ Daimler Trust earns lease payment revenue from leases it purchases together with titles to the leased cars from Dealers via loans from MBFS USA, LLC (“MBFS”).
- ❑ MBFS securitizes and sells auto-lease asset backed securities (“ABS”) to the underwriters for cash.

# Facts: Industrial Business – Car Sales

## ❑ **MBUSA = Wholesale Market**

- ❖ Return on Car Sales **9.4% in 2017, 7.8% in 2018** (FTB Brief, Exh. F.)

## ❑ **MBUSA + Dealers = Purchase and Sale Agreement**

- ❖ Does not provide for a repurchase of cars that Dealers lease
- ❖ Does not set any expectations as to the Dealers' car leases

## ❑ **No separate agreement or condition that “undoes” original car sale.**

## ❑ **Apportionable Income = Car Sales revenue – expenses, incl. COGS**

## ❑ **Apportionment Factor = Gross Receipts from Car Sales**

# Facts: Financial Services Business – Car Leases

## ❑ MBFS & Daimler Trust = Finance & Securities Markets

❖ Return on Equity 17.7% in 2017, 11.1% in 2018 (FTB Brief, Exh. F.)

## ❑ Dealer's Agreement with Lessee assigns Lease to Daimler Trust.

❖ Dealer, as Lessor, simultaneously leases Dealer's car to Lessee and assigns the lease, together with the title to the leased car, to Daimler Trust in a single transaction.

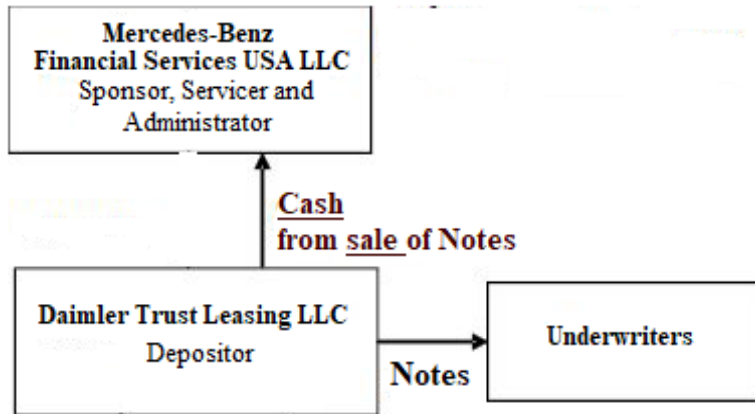
## ❑ Taxpayer's Reply: Law prohibits Daimler from leasing cars it owns.

❑ **Apportionable Income = Car Lease revenue – expenses, incl. depreciation**

❑ **Apportionment Factor = Gross Receipts from Car Leases**

# Facts: Financial Services Business – Securitization & Sale of ABS to Underwriters

- ❑ Lease Payments (accrual method accounting) vs. MBFS' cash sale of auto-lease ABS to Underwriters (cash method accounting):



## 7. Underwriting Agreement

- the Depositor sells the offered Notes to the underwriters
- the underwriters purchase the offered Notes and offer them to investors

- ❑ Idaho State court case which Taxpayer uses to support its “double counting” argument is **not applicable and is distinguishable**.

# No Evidence of “Repurchase” or “Double Counting”

- ❑ MBUSA’s wholesale car sale to Dealers is a separate transaction which does not call for repurchase of cars Dealers later lease.
- ❑ Financial Services Business unit is not in the business of buying cars.
- ❑ Dealers lease cars & assign leases along with titles to the leased cars to Daimler Trust in a single & unrelated transaction to the car sales.
- ❑ Not a single agreement supports a separate repurchase transaction.
- ❑ **None of Daimler’s separate business transactions with unrelated parties were intercompany transactions.**

# Apportionment: Industrial Business & Financial Services Business Markets' Activities in California vs. U.S.

- During audit, Taxpayer reported the extent of its Car Sales to California Dealers and Car Leases to California retail customers over respective U.S. activities as:

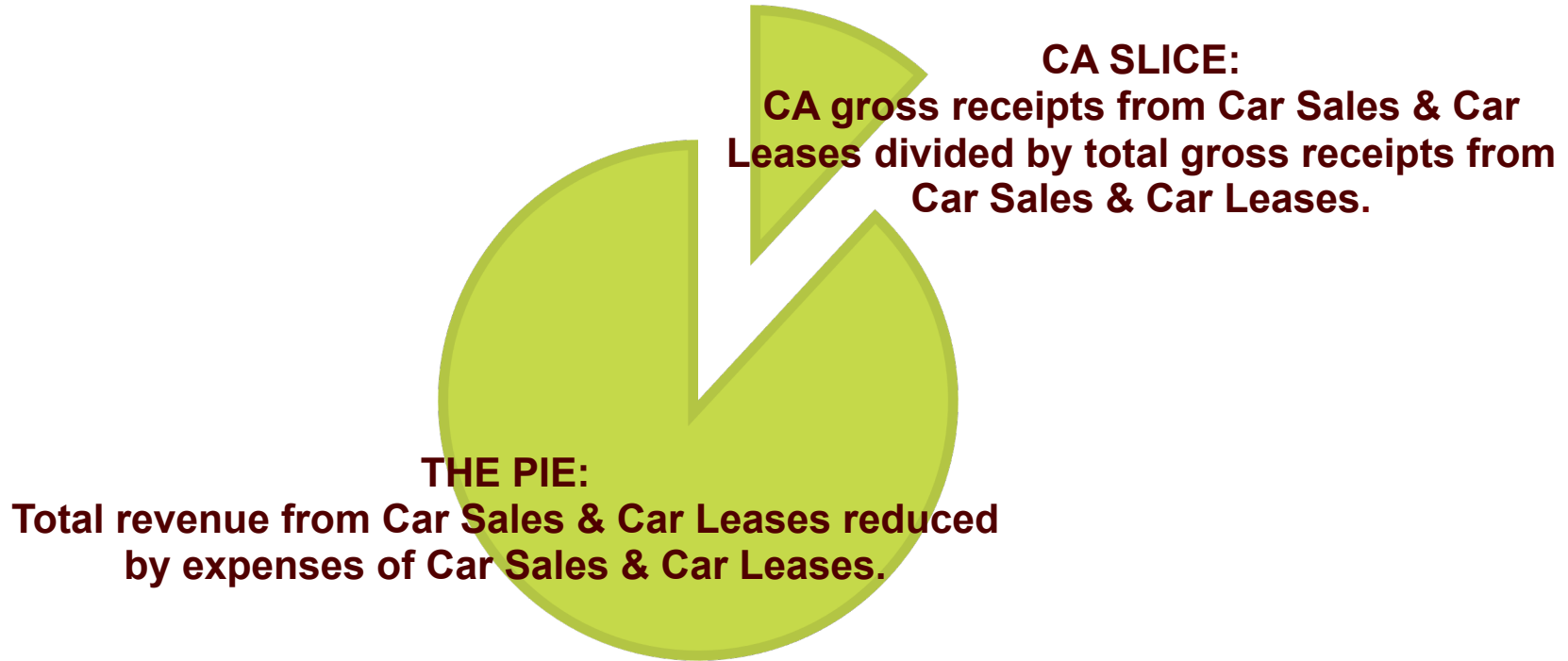
	2017	2018	2019
CA/US Car Sales	11.5%	11.7%	11%
CA/US Car Leases (Fin. data per S.E.C.)	26.05%	27.22%	27.28%
Average CA/US Car Sales & Car Leases	<b>19%</b>	<b>19%</b>	<b>19%</b>

- Standard Apportionment:

<b>12.48%</b>	<b>13.38%</b>	<b>13.51%</b>
---------------	---------------	---------------

# Apportionable Income vs. Apportionment Formula: Car Sale to Client # 1 and Car Lease to Client # 2

---





# Apportionment formula: Fair Representation

- ❑ Standard single sales factor apportionment formula is fair.
- ❑ Factor representation of distinct business activities:
  - ❖ **Business Activity # 1: Car Sales**
    - ✓ Apportionable Income: Car Sales revenue – expenses, incl. COGS
    - ✓ Apportionment Factor: Gross receipts from Car Sales
  - ❖ **Business Activity #2: Car Leases**
    - ✓ Apportionable Income: Car Lease revenue – expenses, incl. depreciation
    - ✓ Apportionment Factor: Gross receipts from Car Leases
- ❑ Earning two separate streams of revenue in two distinct business transactions is not double counting.

# Taxpayer-Proposed Formula Does NOT Fairly Reflect Taxpayer's California Activities

- ❑ Taxpayer wants to reduce MBUSA's actual gross receipts from its completed car sales in the amount calculated by reference to Daimler Trust's total lease acquisition costs.
- ❑ Financial Services Business' subsequent and separate retail lease acquisition from Dealers does not "undo" previously completed car sales by Industrial Business to Dealers wholesale.

# Difference in Methodologies Does NOT Prove that Standard Formula is Unfair

- ❑ While Taxpayer directed significant business activities to California businesses and consumers, it requests a formula that represents less than its actual California business activities.
- ❑ “Revenue and Taxation Code section 25137, does not authorize deviation from UDITPA's normal provisions simply because one purports to have found a better approach.” (*Appeal of Kikkoman International, Inc.*, 82-SBE-098, June 29, 1982.)

# Taxpayer Did NOT Meet its Burden of Proof: Standard Formula is Fair

- ❑ Taxpayer did not sustain its burden proving by clear and convincing evidence that application of the standard formula unfairly represents the extent of its California business activity.
- ❑ A formula that separately factor represents each business activity that contributes to the apportionable business income to a similar extent fairly represents the extent of such business activities.

# Where do we go from here?

---

- ❑ Standard single sales factor apportionment formula is fair because it calls for separate factor representation of distinct business activities in terms of gross receipts from these activities.
- ❑ Reasonableness of the alternative Taxpayer proposes is not an issue given that Taxpayer failed to carry its burden of proving by clear and convincing evidence that the standard rule is unfair.

# Taxpayer's Proposed Alternative vs. Standard Formula

---

	2017	2018	2019
Standard Apportionment Formula	<b>12.48%</b>	<b>13.38%</b>	<b>13.51%</b>
Taxpayer's Proposed Alternative	8.87%	10.17%	10.5%

# Taxpayer Did NOT Meet its Burden of Proof: Proposed Alternative Formula is NOT Reasonable

---

- ❑ Taxpayer's proposed alternative formula is unreasonable because it does not fairly reflect Taxpayer's distinct business activities, each of which separately and proportionally contributed to Taxpayer's total apportionable income.
- ❑ Taxpayer's premise that lease acquisition "undoes" the sale of cars wholesale is inconsistent with its own claiming of the expense deduction related to the same car twice.

# Taxpayer Did NOT Meet its Burden of Proof: Proposed Alternative Formula is NOT Reasonable

- ❑ **Apportionment Factor:** Taxpayer treats Car Leases as transactions that “undo” prior Car Sale transactions.
- ❑ **Apportionable Income:** Taxpayer does not treat Car Leases as transactions that “undo” prior Car Sale transactions.
- ❑ If one transaction “undoes” another, unrelated transaction, Taxpayer is not entitled to claim one of the following deductions:
  1. Cost of cars sold, claimed against car sales revenue, or
  2. Depreciation of the leased cars, claimed against lease revenue.



# Apportionable Income vs. Apportionment Formula

## Standard Apportionment Method

**CA gross receipts from Car Sales & Car Leases divided by total gross receipts from Car Sales & Car Leases.**

**THE PIE:**

**Total revenue from Car Sales & Car Leases reduced by expenses of Car Sales & Car Leases.**

## Proposed Alternative

**CA SLICE:**  
Same as under “Standard Apportionment Method” **LESS**  
**Lease Acquisition Costs.**

**THE PIE:**

**Same as under “Standard Apportionment Method.”**

# Conclusion

---

- ❑ Taxpayer did not carry its 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.
  
- ❑ Standard formula fairly represents the extent of Taxpayer's California business activity.

# Questions