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SUBJECT: Analysis of Treasury Receipts After the California Supreme Court's decisions in  
*Microsoft* and *General Motors*

### **QUESTION(S) PRESENTED**

1. What information should be collected at Audit with respect to treasury activities as a result of the California Supreme Court decisions in *Microsoft* and *General Motors*?
2. Should information be collected with respect to repurchase agreements, commonly referred to as "repos"?

### **CONCLUSION(S)**

1. Information should continue to be collected with respect to all treasury activities so that the circumstances of each case can be compared to the analysis and metrics (measuring tools) provided in *Microsoft*, *General Motors*, and other cases. Those cases do not establish bright-line tests or limit the approaches that can be used.
2. Yes.

### **ANALYSIS AND DISCUSSION**

#### **Background**

The courts have now issued three published decisions addressing issues arising from the attempted inclusion of receipts from treasury activities in the sales factor of the apportionment formula: *Microsoft Corporation v. Franchise Tax Board*, (2006) 39 Cal.4th 750, *General Motors Corporation v. Franchise Tax Board* (2006) 39 Cal.4th 773, and *The Limited Stores Inc. v. Franchise Tax Board* (2007) 152 Cal.App.4th 1491. In addition, there is at least one published State Board of Equalization decision, *Appeal of Pacific Telephone & Telegraph*, 78-SBE-028,

May 4, 1978, addressing aspects of this question. This Board of Equalization opinion was discussed favorably in the court decisions. These recent decisions, other than *General Motors* which addresses an issue other than distortion, have provided some benchmarks and analytical tools that can be used to support a conclusion that reflecting treasury activities in the apportionment formula can frequently give rise to distortion – an unfair reflection of activities within a state. These decisions, however, do not limit the evidence that can be considered or the analytical tools that can be applied, and most importantly, they have not clearly indicated what is not distortive. In other words, there is no single, clear answer on whether inclusion is appropriate, or not, and therefore as much information as possible is needed in order to determine whether inclusion of treasury activities in the sales factor is distortive in a particular case.

The cases establish an analytical framework for approaching these questions and several metrics that can be used to determine if distortion exists from a qualitative perspective. However, these metrics are only illustrative and do not preclude the use of other metrics or tools. The cases provide clear examples of what is distortive under several types of analyses, but do not provide bright-lines for the level of treasury activity that may be included in the sales factor without being distortive. Moreover, they proscribe no limitations on the type of analyses that may be used.

These cases inform:

- 1) As to what constitutes a gross receipt generally,
- 2) That only the income portion of the amount received from repos constitutes gross receipts, and
- 3) What was sufficient to establish distortion in those cases.

Unfortunately, they leave a number of unanswered questions. Specifically, among others, what investment instruments, other than repos, do not give rise to gross receipts upon disposition; and most importantly, what level of treasury activity may be reflected in the sales factor, if any, without being distortive?

### Qualitative Analyses

One of the most important things the recent cases have emphasized is that the question of distortion is primarily, if not exclusively, qualitative in nature. Specifically, the recent court cases have each observed that a treasury function is qualitatively different from the principal or primary business of a company. To establish the qualitative difference, the department must determine the taxpayer's main line of business, and then determine whether the examined activity can be classified as part of the main line, or one of the main lines of business. For most companies, even though the treasury function is a fundamental part of the business (see, *The Limited*), it is not one of the main lines of the business. As a result the treasury function is often virtually *per se* qualitatively different.

The fact that a treasury function is qualitatively different is illustrated by several quantitative metrics used in the courts' opinions:

The number of employees involved in the treasury function as compared to the number of other employees in the main line of business.

The gross margin from the treasury function (treasury income divided by treasury receipts) compared to the gross margin from other activities (net income less treasury income, (net income less treasury income, divided by gross receipts less treasury receipts).<sup>1</sup>

The percentage of total income that would be assigned to the location of the treasury function under the apportionment formula by including the treasury gross receipts. (The formula for this is treasury receipts divided by the denominator of the sales factor (including the treasury receipts) times the weighting of the sales factor (1/3 or 1/2 depending on the weighting of the sales factor).)<sup>2</sup>

The percentage of total income that would be assigned to the location of the treasury function under the apportionment formula compared to the percentage of income earned from treasury activity.<sup>3</sup>

With respect to these quantitative metrics the cases illustrate what has been found to be distortive, but they do not define what is not distortive.<sup>4</sup>

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<sup>1</sup> It can be argued that gross profit or income, rather than net income, is a better comparison because treasury income is generally a gross number and therefore an apples-to-apples comparison should be based on gross amounts. .

<sup>2</sup> For example, in *Appeal of Pacific Telephone* the State Board of Equalization found that more than 11 percent of the taxpayer's activity (treasury receipts amounted to 34 percent of the total receipts, which, when divided by three (for a single-weighted sales factor), equaled more than 11 percent) would be assigned to the location of Pacific Telephone's treasury department.

<sup>3</sup> In *Appeal of Pacific Telephone*, including the treasury activity in the apportionment factor assigned more than 11 percent of the income to the location of the treasury activity, but treasury activity accounted for only 2 percent of the company's income.

<sup>4</sup> It should be noted here that the percentages in *Appeal of Merrill, Lynch, Pierce, Fenner & Smith, Inc.*, 89-SBE-017, June 2, 1989, are not relevant to this inquiry because the trading activity in *Merrill Lynch* was the taxpayer's main line of business, and thus, not qualitatively different than the activity being analyzed in treasury function cases. Also, the percentages discussed in *Container Corp. of Am. v. Franchise Tax Board* (1983) 463 U.S. 159, and *Colgate-Palmolive Co. v. Franchise Tax Board* (1994) 512 U.S. 298, are not relevant because they involved consideration of whether distortion had risen to a level of constitutional significance.

It is likely that an alternative sales factor calculation would be required under Revenue and Taxation Code section 25137 if the levels of distortion already found to be distortive with respect to any of the tests exist. The fact that the levels of distortion found in any of these tests, or other tests, do not exist does not necessarily mean that an alternative formula under section 25137 cannot be required. In point of fact, distortion warranting an alternative formula has been found in all the cases that have been decided since the *Microsoft* decision; thus, no bright line has been established to demonstrate the **lack of** distortion.

So, as an example, in the three cases when inclusion of treasury gross receipts in the apportionment formula assigned 24 percent (*Microsoft*), 11 percent (*Pacific Telephone*), or 9.25 percent (*The Limited*) of a taxpayer's total activity to the location of the treasury function, it was found to be distortive to include the gross receipts. These cases do not state the "lower limit" of distortion that would be acceptable; they only indicate what has been found to be distortive in these cases and therefore will likely be found to be distortive in other cases. It should be noted that even these percentages might not be absolute. As outlined above, it may be appropriate to compare the percentage of activity assigned by inclusion of the treasury function receipts to the percentage of net income produced by the treasury function. It should also be noted that each of these cases addressed the circumstances of a single year. Comparisons should be made both year-by-year and by averaging the results for several years.

#### Why Collecting Repo Information Is Necessary

Complete information with respect to repos, including returned capital, is necessary in order to verify the amount of receipts that should be included in the denominator of the sales factor under Revenue and Taxation Code section 25120. In *Microsoft*, the California Supreme Court determined that the section 25137 distortion analysis requires a full analysis of the treasury department activity, including the profit margins on **all** of the transactions involved.<sup>5</sup> This is not possible without access to data reflecting all transactions, including repos.

Specific reasons why the repo information is required for analytical purposes include:

The treasury activity percentages in *Microsoft*, and probably in *Pacific Telephone* and *The Limited*,<sup>6</sup> included the gross proceeds from repos in calculating these percentages.

While it may be true that the Court in *General Motors* said the gross proceeds from repos are not sales, that does not change the fact that the distortion analyses in the other cases appear to have included repos.<sup>7</sup> If these percentages are meaningful we need to know the

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<sup>5</sup> See Footnote 6 in *Microsoft*, where loan repurchase agreements are listed along with other securities.

<sup>6</sup> In *The Limited*, the court assumed without deciding that "offshore deposit instruments" should be treated similarly to repos.

<sup>7</sup> Furthermore, no distortion analysis was conducted by the court in *General Motors*. The case has been remanded to the trial court to consider the question of whether distortion exists in the circumstances of that case.

repo amounts, including the gross proceeds, so similar items (i.e., gross receipts from main line of business with gross receipts from treasury activity) can be compared. If the return of capital from repos is removed, and the taxpayer still meets these percentages outlined above, an alternative formula would be appropriate because removing repos in the three cases would lower the percentage assigned to the treasury function.

One of the quantitative metrics used by the courts in the distortion analysis involves the gross margins earned on the treasury and non-treasury receipts. For this reason, the gross proceeds from repos, including returned capital (principal), as well as the interest income and net gain realized, is required to compute the gross margins on 1) total treasury activity, 2) the repo element of treasury activity, and 3) the other treasury activity. A gross margin analysis is not keyed to what is included in the sales factor.

Taxpayers' treasury functions involve a number of types of investments and activities, but they are all done for the same purpose. It is arguably inappropriate to treat, for factor purposes, one type of investment or activity differently from another type of investment or activity done for the same purpose in performing a distortion analysis. That is, if returned principal from repos is excluded, returned principal from other activities or investments should be treated in a manner identical to repos; and if not, information is needed to analyze why they should be treated differently.

Even if all treasury activities should not be treated the same, there may be other investments or activities that are similar to repos. This similarity can only be analyzed if the facts related to the repos, as well as the other investments or activities, are known.

#### Examples of Calculations Using Repo Information to Determine Whether Including Treasury Receipts Results In Distortion

Outlined below are some mathematical examples of how the repo information might be used in calculating treasury activity gross margins. To simplify the formulas, letters have been assigned to certain preliminary determinations:

“A” represents all treasury gross proceeds, including the return of principal from repos, as well as all interest income and net gains.

“B” represents the proceeds from repos other than interest and net gains, i.e., the returned capital.

“C” represents all treasury function investment income (interest income and net gains), but not the return of capital.

“D” represents the interest income and net gains from repos.

“E” represents all gross receipts of the taxpayer, including treasury function and repo return of capital.

Mathematical formula comparisons might be as follows:

Treasury Gross Margin including repos return of capital	C/A
Treasury Gross Margin without repos return of capital (reflects <i>General Motors</i> )	C/(A-B)
Treasury Gross Margin excluding repos entirely	(C-D)/(A-B-D)
Percentage of receipts attributable to gross treasury activity (including repos return of capital)	A/E
Percentage of receipts attributable to treasury activity (GM) (without repos return of capital)	(A-B)/(E-B)

#### Other Issues

The department did not contest two other potential questions in either *General Motors* or *Microsoft*:

First, the department did not contest the inclusion of sales proceeds realized from the sale or disposition of securities prior to maturity. A distortion analysis should apply equally to those transactions as it does to securities held to maturity. It should not be assumed that sales of securities prior to maturity should be included. In this regard it is noted that one of the elements relied upon by the *Microsoft* Court in determining what constituted gross receipts was the department's treatment of sales prior to maturity and the Court's conclusion that return of capital should be treated in the same manner.

Second, none of these cases have addressed the question of whether interest and net gains with respect to treasury activities **must** be included in the sales factor. In *Microsoft* and *The Limited*, the department included these receipts as its section 25137 alternative, and the courts held that they must defer to the department's judgment if reasonable. That does not mean that other alternatives could not have been used and also would have been found to be reasonable.

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