1. Where are we today?

The California Supreme Court decisions in Microsoft vs. Franchise Tax Board and General Motors vs. Franchise Tax Board leave us with a factually detailed case-by-case analysis that must be performed by both taxpayers and the Franchise Tax Board in order to determine the correct amount of receipts that are to be included in the sales factor of the apportionment formula.

The decision in Microsoft did not involve a consideration of the individual character of the various investments. Instead, the Court assumed that the proceeds received on all investments represented receipts for sale factor purposes. The Court held that even when an activity gives rise to receipts includable in the sales factor under the standard formula, the receipts might be excludible from the sales factor due to distortion. Microsoft held that the treasury function could give rise to receipts well in excess of the amounts necessary to properly reflect treasury function activity for apportionment purposes and that if this is proven to be the case, the amount can be reduced to net income only. If either the Franchise Tax Board or the taxpayer wishes to make such a showing to reduce the receipts included in the sales factor, they must do so by providing evidence strong enough to meet the standard of "clear and convincing".

General Motors sets forth that not all investments give rise to receipts based on the amount received at disposition. General Motors held that repurchase agreements were secured loans and that the proper amount to include as a gross receipt from this type of investment was the interest income received by the taxpayer. The Court stated, "The repayment of a loan is never considered a receipt". Unfortunately, the Court does not provide a clear definition of what investments it would consider to be loans. This sets up a factual analysis that must be performed in order to determine the amount of receipts that arise from treasury function activities. Clearly repurchase agreement investments give rise to a receipt that is equivalent to the interest earned while the agreement was in effect. What about other types of transactions, such as bank accounts, CDs or other types of time deposits? This remains unclear.

Both cases leave issues to be decided on a case-by-case basis.

- There is no bright line for distortion; at most we know what was decided in the circumstance of one or two cases.

- There is no bright line standard or test to determine if there is distortion, all we have is an analysis of the facts in a particular case with the conclusion that that was distortive.

- We know that only the interest received and net gains are includible for loans but there is no clear definition of what constitutes a loan for purposes of determining gross receipts.

- There may be other issues that have not been explored as to how to treat deposits with banks or other financial institutions that may or may not be loans.

Many, but not necessarily all, of these issues may be addressed in pending litigation.

2. Where should we be going?

Franchise Tax Board believes that the current state of the law is not workable for either the Department or taxpayers and should be changed by providing a simple, straightforward rule that is easy to apply. This rule should apply to all taxpayers regardless of whether the treasury function occurs in California or not, and the rule should be as uniform as possible with the rules of other states in order to avoid over or under taxation of the taxpayer's income.

The primary goal should be to address the problem on a forward going basis. The goal is not to resolve all pending matters. A forward going solution may provide a guide for resolving years where returns have been filed or provide a basis for the parties to evaluate the risks inherent in continued litigation.

3. What do the laws of other states provide on this issue?

As the Court stated in <u>Microsoft</u>, numerous other states have amended their respective income apportionment statutes to expressly exclude investment returns from the sales factor. Examples of this include:

Florida Statutes Annotated, section 220.15, subdivision (5)(a):

"As used in this section, the term "sales" means all gross receipts of the taxpayer except interest, dividends, rents, royalties, and gross receipts from the sale, exchange, maturity, redemption, or other disposition of securities . . ."

Similarly Massachusetts law (Massachusetts General Laws, chapter 63, section 38(f)) provides that "sales" means all gross receipts of the corporation except interest, dividends, and gross receipts from the maturity, redemption, sale, exchange or other disposition of securities."

Other states, such as Hawaii, have adopted alternative rules that reduce the receipts of the treasury function to net income based on distortion, usually under the equivalent of our section 25137. Hawaii Administrative Rule 18-235-38-03(f) provides:

> Where gains and losses on the sale of liquid assets are not excluded from the sales factor by other provisions under this section, such gains or losses shall be treated as provided in this subsection. This subsection does not provide rules relating to the treatment of other receipts produced from holding or managing such assets. If a taxpayer holds liquid assets in connection with one or more treasury functions of the taxpayer, and the liquid assets produce business income when sold, exchanged or otherwise disposed, the overall net gain from those transactions for each treasury function for the tax period is included in the sales factor. For purposes of this subsection, each treasury function will be considered separately.
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> (1) For purposes of subsection (f), a “liquid asset” is an asset (other than functional currency or funds held in bank accounts) held to provide a relatively immediate source of funds to satisfy the liquidity needs of the trade or business. “Liquid assets” include foreign currency (and trading positions therein) other than functional currency used in the regular course of the taxpayer's trade or business; marketable instruments (including stocks, bonds, debentures, options, warrants, futures contracts, etc.); and mutual funds which hold such liquid assets. An instrument is considered marketable if it is traded in an established stock or securities market and is regularly quoted by brokers or dealers in making a market. Stock in a corporation which is unitary with the taxpayer, or which has a substantial business relationship with the taxpayer is not considered marketable stock.
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> (2) For purposes of subsection (f), a “treasury function” is the pooling and management of liquid 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, providing a reserve for business contingencies, business acquisitions, etc. A taxpayer principally engaged in the trade or business of purchasing and selling instruments or other items included in the definition of liquid assets set forth herein is not performing a treasury function with respect to income so produced.
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> (3) For purposes of subsection (f), “overall net gain” refers to the total net gain from all transactions incurred at each treasury function for the entire tax period, not the net gain from a specific transaction.

The Department's research indicates that a majority of states have affirmatively indicated, either through statutes, rules or regulations that the correct answer is to exclude these receipts, either entirely, or to the extent they exceed net income derived from the treasury function.

Twenty-five states have dealt with the treasury function through removal of these receipts from the definition of gross receipts. Of these twenty-five, fifteen have done so by statute, seven by regulation and three by administrative rule. There are also six states that have dealt with the issue by limiting treasury function receipts to net income through regulation under a distortion statue. None of these states include in their rules a level of inclusion above net income for treasury function receipts.

4. What should the law in California be on a going forward basis?

Any solution to this ongoing problem should be guided by core principles that provide an objective basis upon which to evaluate the proposed solution. Among these principles are:

1) Equity: Are all taxpayers being treated similarly?
2) Administrability: Is the rule clear and simple. Can taxpayers and the Department apply the rule?
3) Eliminate potential disputes: Does the new rule raise new concerns that could lead to new disputes?
4) Uniformity with other states: Is the solution consistent with the laws of other states such that under taxation or double taxation does not occur?

In addition to these principles, there will always be concerns about the ability to determine the revenue impact of a proposal. Rules that envision the use of elections or are based on individual taxpayer circumstances will be very hard to measure and may well fail on the basis that the fiscal impact of the rule is not determinable.

After reviewing the laws of other states, it is clear that the most accepted response to this issue in other jurisdictions is to remove these receipts entirely, or at a minimum to reduce them to net gains. This could be accomplished legislatively by amending section 25120 to redefine the term "sales" contained in 25120(e).

Another alternative would be to act by regulation to exclude treasury function receipts under section 25137. This alternative would acknowledge the decisions of the California Supreme Court in <u>General Motors</u> and <u>Microsoft</u> by agreeing that the receipts are includable under the standard formula, yet exclude them, not on a case-by-case basis, but on a systematic basis.

The ability to proceed under 25137 would continue to exist in either circumstance for either the taxpayer or the department. If a taxpayer feels that this exclusion is distortive, they could petition for relief from the regulation under the authority of section 25137. The department believes, however, that this would be a rare circumstance.

Either of these alternatives would put California on a level playing field with other states and provide clarity for taxpayers.

The department will discuss these methods, as well as any other possible solutions at the interested parties meeting, keeping in mind that the underlying objective should be to replace the current case by case analysis with a simple, straightforward rule that is easily complied with by taxpayers and easily administered by the department, with all taxpayers treated equally.